

THE FEDERAL RESERVE BOARD

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HOME OWNERSHIP AND EQUITY PROTECTION ACT (HOEPA)

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PUBLIC HEARING

+ + + + +

Thursday
June 14, 2007

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The public hearing came to order at 8:43 a.m. in the Terrace Level Dining Room of the Martin Building, 20th and C Streets, N.W., Washington, D.C., Federal Reserve Board Governor Randall S. Kroszner, presiding.

PRESENT FROM THE FEDERAL RESERVE:

Randall S. Kroszner	Governor, Board of Governors of the Federal Reserve System
Sandra F. Braunstein	Director, Division of Consumer and Community Action
Leonard Chanin	Associate Director, Division of Consumer and Community Affairs

MORNING PANEL:

Janis Bowdler	Senior Housing Policy Analyst, National Council of La Raza
William H. Brewster	Director of Anti-Fraud Initiatives, Fannie Mae
Alys Cohen	Staff Attorney, National Consumer Law Center
Susan A. Davis	Executive Vice President, National Consumer Lending, Wells Fargo Home Mortgage

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Harry Dinham	President, National Association of Mortgage Brokers
Martin Eakes	Chief Executive Officer, Center for Responsible Lending/Self-Help
Ira Rheingold	General Counsel, National Association of Consumer Advocates
Pablo Sanchez	National Mortgage Production Specialist, JP Morgan Chase
Faith Schwartz	Senior Vice President, Enterprise Risk Management and Public Affairs, Option One Mortgage Corporation
<u>AFTERNOON PANEL:</u>	
Steve Antonakes	Commissioner of Banks, Massachusetts
Michael Decker	Senior Managing Director, Research and Public Policy, Securities Industry and Financial Markets Association
Ren Essene	Research Analyst, Harvard University
Joseph R. Mason	LeBow College of Business, Drexel University
Tom Miller	Attorney General, Iowa
Mark Pearce	Deputy Commissioner of Banks, North Carolina
Lori Swanson	Attorney General, Minnesota

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P R O C E E D I N G S

8:43 a.m.

1
2
3 GOVERNOR KROSZNER: All right, good.
4 Hopefully we won't be getting any feedback. But we do
5 want feedback from you guys, and that's exactly why
6 we're having this hearing today.

7 I really want to welcome everyone for
8 coming, and hopefully we won't be getting too much
9 feedback from the audio problems, but we'll be getting
10 feedback from you.

11 This is an incredibly important topic, and
12 I'm really delighted to see the interest that people
13 have with a full house here. We have a lot of
14 important discussions throughout the day, a lot of
15 good back and forth.

16 We have some superb panelists. We also
17 have an opportunity for the open mike at the end, for
18 people who have not formally participated in the
19 panels, to come forward. I'll talk about that a
20 little bit more in just a moment.

21 Also, I'm Governor Kroszner, and I chair
22 the Consumer and Community Affairs Committee, as well
23 as the Supervision and Regulation Committee. Sandra
24 Braunstein is the head of our Consumer and Community
25 Affairs Division, and Leonard Chanin is her key deputy

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1 on these issues.

2 So we're very pleased that they could come
3 here today to participate in this event.

4 Well, as I said, I'm really happy to be
5 able to chair the Federal Reserve Board's public
6 hearing under the Home Ownership Equity Protection
7 Act, so-called HOEPA. The hearing will focus
8 specifically on how the Board might use its rule-
9 making authority under HOEPA to address concerns about
10 home mortgage lending practices.

11 During the course of this hearing, we'll
12 hear from key players in the home mortgage market,
13 lenders, brokers, secondary market participants,
14 consumer advocacy groups and community development
15 organizations, academics, researchers and state
16 regulators.

17 Although they all play very different
18 roles, they share a common goal, I believe, in
19 encouraging responsible mortgage lending for the
20 benefit of individual consumers and the American
21 economy as a whole.

22 The Congress enacted HOEPA in 1994 in
23 response to concerns about abusive lending in the home
24 equity market. The Federal Reserve Board was given
25 broad authority to implement its provisions, and to

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1 adopt regulations to implement its provisions, when
2 the Board finds it to be necessary and proper to
3 effectuate its purposes.

4 In addition, the Board has the
5 responsibility to prohibit acts or practices it finds
6 unfair or deceptive, or otherwise designed to evade
7 HOEPA. The Board understands its rule-making
8 responsibility under HOEPA, but is not alone in facing
9 the important task of preventing unfair or deceptive
10 practices.

11 Other regulators share a responsibility to
12 ensure responsible mortgage lending through
13 enforcement powers. The states have extensive
14 regulatory authority and responsibility under their
15 own anti-predatory lending statutes and various other
16 legal authorities, and especially their mortgage
17 industry licensing acts, which give them considerable
18 control over the activities of mortgage brokers and
19 lenders.

20 Many of the states, including notably
21 those that are represented on this afternoon's panel,
22 have been very active, very, very active in reining in
23 bad actors in the mortgage markets. The FTC also
24 shares our enforcement responsibility under HOEPA and
25 other federal laws.

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1 Finally, the federal financial regulatory
2 agencies each have a duty to enforce federal consumer
3 protection laws, including HOEPA, with respect to
4 depository institutions under their respective
5 regulatory ambits.

6 In light of the sheer magnitude of the
7 task, we're very pleased that these regulators all
8 contribute to the goal of ensuring a healthy,
9 competitive and responsible mortgage market.

10 We are committed to working closely with
11 the other federal and state regulators, to ensure that
12 the laws that protect consumers are enforced.

13 HOEPA also directs the Board to hold
14 hearings, such as the one we're holding today, to
15 assess the effectiveness of regulations and laws in
16 protecting consumers. Hearings provide us with very
17 valuable information.

18 In our most recent prior hearings held
19 last summer in four cities around the country, our
20 goals included assessing the effectiveness of our 2001
21 amendments to the HOEPA rules, in curbing abusive
22 lending practices while preserving access to credit.

23 We also wanted to gather information on
24 the effectiveness of the mortgage disclosures required
25 by our Regulation Z, pursuant to the Truth in Lending

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1 Act, to inform a review of those disclosures, which is
2 now actively underway.

3 Rising foreclosures in the subprime market
4 over the past year have led the Board to consider
5 whether and how it should use its rulemaking authority
6 to address these concerns. In doing so, however, we
7 must walk a fine line.

8 We must determine how we can help to weed
9 out abuses, while also preserving incentives to
10 responsible lending. A robust and responsible
11 subprime market benefits consumers, by allowing
12 borrowers with limited credit histories to become
13 homeowners, to access equity in their homes, or have
14 the flexibility to refinance their loans as needed.

15 In this task, we have several tools at our
16 disposal. These include required disclosures by
17 lenders, rules that prohibit abusive practices,
18 principle-based guidance with supervisory oversight,
19 plus formal efforts to work with industry participants
20 to promote best practices, and consumer education
21 materials.

22 The Federal Reserve currently is
23 conducting a thorough review of its policies with
24 respect to each of these tools. Last year, together
25 with the other federal banking regulators, we issued

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1 guidance on so-called non-traditional mortgages.

2 We also have issued proposed supervisory
3 guidance concerning underwriting standards to
4 disclosures for subprime mortgages. The agencies are
5 finishing their review of these comments and the
6 comments we've received, and expect to issue a final
7 version fairly soon.

8 The Federal Reserve produces a range of
9 consumer education materials, including information to
10 help potential borrowers under adjustable rate and
11 other alternative mortgage products. We actively
12 promote financial education by partnering with outside
13 organizations, as well as doing a number of activities
14 on our own that I've been very heavily involved with,
15 having been an educator for many years. I think it's
16 very important to make sure to get the ideas out
17 there.

18 Two tools that we'll focus on today,
19 however, are lending disclosure to consumers and rules
20 that prohibit or restrict lending practices.
21 Disclosures provide information that is critical to
22 the effective functioning of markets. A core
23 principle of economics is that markets are more
24 competitive and therefore more efficient when accurate
25 information is available to all who participate.

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1 Information helps consumers by improving
2 the ability to compare mortgage products and then
3 choose the ones that will help meet their best -- best
4 meet their personal goals.

5 We are keenly aware, however, of the
6 substantial volume of disclosures of the documents
7 that mortgage lending already entails, and we are
8 sensitive to the risk that too much information, may
9 be practically of as little value to consumers as no
10 information at all.

11 Accordingly, we intend to consider
12 mortgage disclosures comprehensively, with an eye
13 towards improving their usefulness to consumers, while
14 remaining mindful of the total burden for the
15 industry.

16 Perhaps most importantly, we'll engage in
17 extensive consumer testing of mortgage disclosures, to
18 ensure that disclosures provide information that
19 consumers can really use. This is one of the things
20 that I'm very excited about, that we really use in the
21 credit card area and we're going to be using in the
22 mortgage area.

23 Not just making sure that the information is
24 there; that's necessary. But there in a way that
25 people can understand and that people find useful.

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1 We found a lot of surprising things, things
2 that we wouldn't have thought about without asking
3 real people, going into shopping malls, people who are
4 going to be using their credit cards, to find out
5 well, what's useful? What do you want to know? What
6 can be helpful?

7 Then when we actually put this down on
8 paper, going back to those consumers and saying "Do
9 you understand this? Is this really helpful to you?"
10 That sort of back and forth process can be very
11 valuable in turning information overload into
12 something that is very valuable and useful to empower
13 consumers.

14 We also recognize that disclosures may not
15 always be sufficient to combat abusive practices.
16 Because some bad lending practices may require
17 additional measures, the Federal Reserve will
18 seriously consider how we might use our rule-making
19 authority to address abusive practices, without
20 restricting consumers' access to beneficial financial
21 options, and responsible subprime credit.

22 In addition to improved disclosures,
23 regulations that restrict or prohibit practices that
24 are "unfair and deceptive" may also be necessary. We
25 have heard concerns about consumers being steered

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1 toward products that they can't afford, and have
2 repeated refinancings involving closing costs that
3 strip away a borrower's home equity.

4 Today, we'll gather information on how we
5 might craft rules to stop such abusive practices. We
6 also will seek information from state officials
7 regarding their experiences with drafting laws and
8 rules that combat predatory lending efficiently and
9 effectively.

10 During today's hearing, we'll seek
11 information from panelists on certain specific
12 questions. I'd like to close by briefly touching on
13 some of those questions. There are four terms or
14 practices that have been most frequently cited as
15 troublesome in the mortgage market, especially in the
16 subprime home equity market.

17 They are first, prepayment penalties.
18 Second, failure to require escrow for taxes and
19 insurance; third, stated income and low documentation
20 lending; and fourth, failure to give adequate
21 consideration to a borrower's ability to repay a loan.

22 At least some of these practices can be
23 beneficial at least to some consumers. For example,
24 an informed borrower might choose a loan with a
25 prepayment penalty in exchange for a lower interest

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1 rate or lower closing costs.

2 On the other hand, prepayment penalties can
3 also be used in an abusive way, such as when a
4 borrower is unaware that an adjustable rate mortgage
5 loan has a substantial prepayment penalty that will
6 extend beyond the first adjustment of the loan's
7 interest rate, making it costly or impossible for the
8 borrower to refinance the loan to avoid higher
9 interest payments.

10 We hope to gather information that helps us
11 to determine whether rules can prevent the abusive use
12 of loan terms or practices, while preserving their use
13 in instances where they might provide benefits to
14 consumers.

15 Given adequate consideration to a borrower's
16 ability to repay a loan obviously benefits both the
17 borrowers and the lenders. Recently, the Board and
18 other federal regulatory agencies issued guidance
19 reinforcing our collective belief that the principles
20 of prudent underwriting require consideration of a
21 borrower's repayment ability.

22 For example, the agencies have provided that
23 lenders should qualify borrowers for non-traditional
24 mortgage products, such as interest-only loans and
25 payment option adjustable mortgage products, based on

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1 the fully indexed rate and fully amortizing payment.

2 Some have urged the Board to adopt this
3 broad principle as a rule, while others have urged the
4 Board to preserve flexibility to exercise judgment in
5 determining the likelihood that a given borrower can
6 repay a loan.

7 Well, it seems self-evident that adequate
8 consideration of repayment ability is necessary. Our
9 experience in crafting guidance has taught us that
10 this principle is far easier to articulate in general
11 terms than it is to put in a detailed prescriptive
12 role, saying which underwriting practice constitutes
13 "adequate consideration."

14 This is especially true in the context of
15 mortgage credit underwriting, which can depend on such
16 a great number of pertinent consumer-specific
17 considerations. Today, with your help, we intend to
18 explore in detail these types of practices, when they
19 can be beneficial and then they might be problematic.

20 We will seek informed suggestions with
21 respect to our four practices I've identified, as well
22 as certainly any others that commenters may identify.

23
24 First, we ask in general whether such
25 practices should be prohibited, restricted or

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1 subjected to increased disclosure requirements and if
2 so, why.

3 Second, we ask whether any new regulatory
4 treatment of such practices should be limited to
5 certain types of loans or certain types of borrowers.

6 Finally, we ask whether any state law
7 provisions relating to such practices might serve as
8 models for the Board to adopt at the federal level,
9 and if so, what kind of record these have -- these
10 state laws in curbing abuses without restricting
11 access to responsible mortgage credit.

12 Your participation here and the welcome
13 pertinent information to be contributed by the
14 panelists and others is very much appreciated and I,
15 the other members of the panel from the Fed here and
16 the entire Federal Reserve Board thank you very much
17 for taking the time to participate.

18 Now what I'd like to do is turn to the rules
19 of procedure that will govern the hearing for today.

20 Each of the invited panelists will have a
21 maximum of five minutes, and because we have so many
22 panelists and so many people who want to speak, I will
23 have to be pretty draconian in making sure that we do
24 enforce that five minute limit, and we have a timer
25 who will publicly tell everyone what the time is and

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1 publicly shame someone who may go over the limit.

2 That's not because we want to reduce debate,
3 but because we want to have a rich debate, in which
4 everyone has an opportunity to speak. There will be
5 questions and answers to follow the conclusions of all
6 of the opening statements. We want to get everyone's
7 position out there before we have the Q and A.

8 The first panel will go until noon, but
9 we'll have a break at some point. So don't worry.
10 This is not going to be a test of will, to make sure
11 that you can make it through to noon. We'll take a
12 break at some point.

13 We'll have an hour long lunch break from 12
14 to 1, reconvene promptly at one. We'll have a second
15 panel of experts from one o'clock to three o'clock
16 with the same procedures of a maximum five-minute
17 presentations, and Q and A.

18 From three o'clock to four o'clock, we then
19 have a so-called open mike. What this will allow us
20 to do is have people who have not been formally
21 invited to the panels, have an opportunity to speak at
22 today's hearings.

23 You must sign up in advance, though.
24 There's a table just outside that door. David Evans
25 is keeping the sign-up list. Each of the

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1 presentations at the mike will be limited to no more
2 than three minutes.

3 Once again, unfortunately I'm going to be
4 very tough on enforcing that limit, because I know
5 that we're going to have a lot of people who want to
6 speak, and I want to make sure that we get through all
7 those speakers.

8 I have two final points that I want to
9 mention. The panelists, the open mike participants,
10 as well as the members of the general public, and
11 anyone, whether they are here or not, are encouraged
12 and we really look forward to written statements of
13 any length being provided to us by August 15th, related
14 to the wide variety of topics that we're talking about
15 today.

16 We do look forward to those written
17 statements. So even though we're keeping the oral
18 presentation short, the written statement they submit
19 will be as long as you wish. A transcript of the
20 panel discussion and the open mike statements will be
21 part of the record, which will be made available on
22 the Board's website.

23 Again, thank you very much for your
24 participation. Now I'd like to begin formally the
25 first panel with Faith Schwartz, from Option One.

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1 MS. SCHWARTZ: Well, thank you very much,
2 Governor Kroszner and the Fed Board staff, for
3 inviting Option One and myself to participate today in
4 this panel. I'll try to get through my introduction
5 within five minutes and we'll get to any key points.
6 But I will do my best.

7 I am the manager of Enterprise Risk
8 Management at Option One Mortgage and our Public
9 Affairs, and I have been there for four years. I'm
10 currently on the Federal Reserve's Consumer Advisory
11 Committee.

12 Option One Mortgage has been in business
13 since 1992, and is a nationwide non-prime wholesale
14 lender, who originates through a network of brokers,
15 and the leaders that started the company are in place
16 today.

17 Before I get into the introductory paragraph
18 that should get to the key points, I would like to
19 share that I have been in the business for many, many
20 years, over 20, and I've spent ten years in banking.
21 I've spent five years at a GSE, Freddie Mac, where I
22 helped them manage their subprime interest and
23 securitization and their anti-predatory lending
24 efforts.

25 I've been an entrepreneur for six years as

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1 a chief operating officer. We've relied on the
2 capital markets to have nationwide funding to operate
3 in the marketplace. I share that with you because I
4 feel I come to this discussion with a pretty informed
5 background on some of the nuances that will be talked
6 about today.

7 So with that, we recommend that the Board be
8 cautious in exercising its rule-making authority under
9 HOEPA, Section 129. But we do recommend that they use
10 their authority in the following three ways.

11 Pursuant to Section 105 of the Truth in
12 Lending Act (TILA), to strengthen and simplify
13 disclosures with respect to all four topics
14 introduced.

15 Secondly, we recommend pursuant to Section
16 129, 1 and 2 of HOEPA, to craft targeted rules with
17 regard to truly unfair acts and practices that are
18 abusive.

19 Three, pursuant to its supervisory
20 authority, deal with most concerns by issuing further
21 regulatory guidance which provides more flexibility
22 than firm regulations.

23 The effectiveness of this guidance has been
24 seen in the rapid and positive transformation of the
25 mortgage market in response to federal regulatory

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1 agencies' non-traditional mortgage guidance, and to
2 the parallel state-adopted, the guidance that was
3 adopted in over 30 states. Option One operates by
4 that guidance in all 50 states.

5 The market has also reflected that guidance,
6 and you have a lot of courses and actions here which
7 shows that it can be quite effective. Such a
8 judicious mixture of targeted formal rules, together
9 with a broader application of general principles in
10 regulatory guidance and greater transparency through
11 better disclosures, is our recommended approach.

12 This path should better protect consumers,
13 create a more level playing field for lenders, and
14 promote conditions that help keep mortgage capital
15 widely available in the communities.

16 I will touch upon briefly some of the key
17 issues you've asked about. More timely plain language
18 disclosures. Clearly, people are not happy with the
19 current level of disclosures, and in some ways, it
20 gets discounted in the market, that they're not
21 relevant because no one's reading them.

22 So we strongly urge the Federal Reserve,
23 under TILA 105, to adopt plain language disclosures
24 across the board on all four issues.

25 We also think the Board should consider a

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1 DVD video medium forum to get to borrowers who just
2 don't read a one-paragraph plain language disclosure
3 as another alternative to reach the borrowers.

4 At Option One, we have several plain
5 language disclosures. Since we are not at the point
6 of sale when the borrower is with our customer, the
7 broker, what we do is make sure if we get a loan with
8 a stated income or interest only or an ARM, we don't
9 know how that loan was shopped.

10 But what we do is we send out a very plain
11 language, 8th grade written paragraph that says exactly
12 what they've applied for and did they understand what
13 they applied for.

14 That is sent directly to the consumer. With
15 any material changes, we re-issue those disclosures
16 and at closing, we also have those disclosures. We'd
17 like to see the Board act on that further.

18 Prepayment penalties are a key issue in the
19 market. I think there's been a lot of debate about
20 them, and we actually think the Board should go
21 through regulatory guidance on some of the issues that
22 surround the prepayment penalty.

23 As a policy matter, we don't think anyone
24 should have a prepayment penalty that doesn't want one
25 or choose one. We think that there needs to be clear

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1 notice and information around prepayment penalties to
2 the borrowers, so that they can make the best
3 assessment of whether they want one.

4 Clear notice and finally, every borrower who
5 gets one should have a benefit for choosing a loan
6 with a prepayment penalty of either rate or fee, or
7 lower rate or fee.

8 We think that that can again go through
9 TILA 105, with clear disclosures on the benefits or
10 lack of benefit of a prepayment penalty. We think
11 carefully crafted, through Section 129, 1 or 2 that
12 includes substantive requirements that a consumer must
13 have a choice to choose a prepayment penalty.

14 They must limit the term of the penalty,
15 maybe to three years, but -- sorry. Should I finish
16 the sentence or? Okay. And let me jump to escrows.
17 We believe the Board should do a lot on escrows as
18 well. But really through regulation, we do think with
19 both 105 and 129, you can make a big impact on a tool
20 that is meaningful if well-applied in the market.
21 Okay.

22 GOVERNOR KROSZNER: Thank you very much.

23 MS. SCHWARTZ: You're welcome.

24 GOVERNOR KROSZNER: And now let's turn to
25 Pablo Sanchez from J.P. Morgan Chase.

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1 MR. SANCHEZ: Good morning to all. Pablo
2 Sanchez, the Retail Business executive for J.P. Morgan
3 Chase, and you have an idea of my business is.

4 I think we're fairly serious about the time
5 element here. Matthew has a sign that he holds up,
6 and actually I think I've seen a stun gun or something
7 there.

8 (Laughter.)

9 MR. SANCHEZ: So on behalf of J.P. Morgan
10 Chase, I would like to thank the Board for the
11 opportunity to participate as a panelist on this very
12 important topic.

13 We strongly support the Board's objective to
14 address the concerns that have been raised regarding
15 certain mortgage practices, while preserving
16 incentives for responsible lenders, to provide
17 mortgages to a wide array of borrowers, particularly
18 subprime borrowers.

19 At Chase, we are committed to help our
20 customers achieve, and more importantly sustain home
21 ownership. The key to our mission is properly
22 evaluating our borrowers' ability and willingness to
23 pay their mortgage with us, and I know we will be
24 speaking about that in more detail today.

25 There are four fundamental principles that

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1 we have developed to guide our business practices in
2 home lending. We want our customers to be informed
3 and to be able to make responsible choices based on
4 their individual circumstances.

5 We want to offer a broad array of mortgage
6 products that address the financial needs and
7 circumstances of our customers, and provide good value
8 at a competitive price. We want to be there if our
9 customers suffer a life event and need our assistance
10 to remain in their home.

11 Finally, we want to provide support to
12 strengthen and sustain the communities in which we
13 live and work. Virtually everything we do is designed
14 around these guiding principles.

15 For example, to inform our customers, we
16 have created financial literacy and mortgage-specific
17 tools and training, and we have made it available on
18 paper, in videos and on the Internet. Currently, we
19 are conducting a four-city tour entitled legacy of
20 home ownership, where we offer educational seminars
21 designed to educate consumers on various aspects of
22 home purchasing and financing.

23 We are also in the process of rolling out
24 the new disclosure, which we have been testing, to
25 answer the most important questions about our loans.

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1 We refer to it as our nutritional label. We aspire to
2 make it simple. I don't know that we're quite there
3 yet, but we are trying.

4 We want to have products that serve all of
5 our customers, including those who may have suffered
6 financial difficulties that affected their credit, or
7 those whose property may not qualify as performing.
8 We see non-performing properties frequently in our
9 urban markets, because many borrowers are on mixed use
10 property.

11 However, in each case, we based our
12 underwriting on the borrowers' ability and willingness
13 to repay, and when we review refinanced applications
14 from subprime borrowers, we conduct a net benefit
15 analysis as well.

16 We are also currently working with our
17 partners in the agencies to design new products,
18 suitable for borrowers with ARM resets who may have
19 affordability concerns. We have always worked on one
20 on one directly with customers, but in 2004, we
21 established our Home Ownership Preservation Office, to
22 help our customers in times of financial stress.

23 This office serves as a portal for non-
24 profit organizations who are assisting our borrowers,
25 to find their way to the right place at Chase. The

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1 office runs a dedicated help line and also trains our
2 non-profit partners about the programs available to
3 help our clients avoid mortgage foreclosures.

4 More broadly, the office works with
5 community leaders and housing advocates to develop
6 foreclosure prevention programs, and has worked
7 closely with the Housing Policy Council, Neighbor
8 Works and the Ad Council on the upcoming national
9 foreclosure prevention campaign.

10 I'm here today to listen, to learn and to
11 provide industry insights wherever I can into the
12 issues that confront all of us, and I look forward to
13 participating. Thank you.

14 GOVERNOR KROSZNER: Thank you very much.
15 Now we're going to turn to William Brewster of Fannie
16 Mae.

17 MR. BREWSTER: Thank you. Is it possible
18 for me to sort of reclaim any of Pablo's time?

19 GOVERNOR KROSZNER: No.

20 MR. BREWSTER: I didn't think so. Thanks.

21 GOVERNOR KROSZNER: We'll give it to Pablo
22 when he's answering questions.

23 MR. BREWSTER: Terrific. Good morning,
24 everyone. Thank you for inviting me to participate.
25 My name is Bill Brewster. I'm the Director of Fraud

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1 Issues for Fannie Mae.

2 My unit is responsible for Fannie Mae's
3 mortgage fraud investigations analysis and reporting,
4 as well as outreach to the industry and our law
5 enforcement on mortgage fraud matters.

6 Fannie Mae's regulator, the Office of
7 Federal Housing Enterprise Oversight, defines mortgage
8 fraud simply as "Material misstatement,
9 misrepresentation or omission relied upon by an
10 enterprise to fund or purchase or not to fund or
11 purchase a mortgage."

12 Over the past two years, we've seen an
13 increase in mortgage fraud incidents, especially those
14 involving mortgages that are processed in the Upper
15 Midwest. For loans originated in 2005-2006, the Upper
16 Midwest and Southeast regions each account for about
17 one-third of our fraud findings.

18 Income misrepresentation remains the most
19 common type of fraud we find, followed by fraud-
20 related to the subject property and its appraised
21 value. An alarming number of Fannie Mae's recent
22 investigations have found that otherwise honest
23 consumers and real estate professionals are fooled
24 into conspiring to commit mortgage fraud.

25 Mortgage fraud perpetrators are highly

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1 imaginative, and then often involve other organized
2 criminal activity. They are highly motivated to take
3 advantage of unsuspecting individuals.

4 In one case we're currently investigating,
5 an attractive website uses religious overtones to lure
6 consumers with comforting promises of credit repair
7 mandatory to home ownership. In reality, the website
8 is operated by an LLC that specializes in buying
9 foreclosed properties and flipping them to home buyers
10 at inflated prices. They use falsified asset and
11 appraisal documentation.

12 To make matters worse, the LLC is owned by
13 an originating loan officer. Consequently, the loan
14 officer collects both the normal commission and
15 excessive sales proceeds on each loan. The loans are
16 subsequently sold on the secondary market to larger
17 lenders and then sold to Fannie Mae.

18 In this case, the consumers appear to have
19 intentionally exaggerated their assets and down
20 payment, in order to qualify for the mortgage loans.
21 But were they aware of how serious those exaggerations
22 were?

23 In another recent case, consumers were
24 induced to rent their credit to what they were told
25 was an investment club. They attended a meeting at a

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1 local hotel, provided their social security numbers
2 and signed blank documents.

3 In return, they received checks for as much
4 as \$5,000. A few months later, two of the consumers
5 were rejected for a car loan because their credit
6 reports showed significant mortgage delinquencies. As
7 it turned out, unbeknownst to them, they were used as
8 straw buyers to purchase multiple properties in other
9 states over 1,000 miles away, and the investment club
10 was actually a property flip scheme used to unload
11 over 100 properties at excessive prices.

12 In such mortgage fraud schemes, it does not
13 matter what the product or the pricing is.
14 Perpetrators often go for the most efficient pricing,
15 and easily fabricate whatever documents are needed.
16 Yet the consumers caught up in these schemes are often
17 the most aggrieved victims of the real estate finance
18 system.

19 Our experience indicates that consumers and
20 all professionals in the mortgage process, including
21 real estate agents, mortgage brokers, lenders,
22 appraisers, title agents, must become better educated
23 on common mortgage fraud schemes and not inadvertently
24 conspire with the perpetrators of those schemes.

25 Clearly, expressed ethical standards applied

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1 consistently make their attractive solicitations of
2 perpetrators less attractive. The FBI and the
3 Mortgage Bankers Association, for example, recently
4 acknowledged as much when they collaborated on a one-
5 page voluntary notice that warns consumers that
6 misrepresenting personal financial information
7 constitutes mortgage fraud, and we have an example --
8 there's an example and there's some in the back, too,
9 that you can see.

10 In light of these concerns, we hope the
11 Board will consider the importance of consumer
12 education, specifically related to anti-fraud
13 education and best practices.

14 At Fannie Mae, we utilize a balance of
15 enforcement, education and information-sharing to
16 address mortgage fraud, product suitability and
17 predatory practices. In 2006, Fannie Mae completed
18 over 25,000 loan filing underwriting reviews, over
19 18,000 specialized predatory lending reviews, and 98
20 case investigations involving over 7,500 loans.

21 We also referred over 300 unacceptable
22 appraisal reports to the appropriate state licensing
23 boards. On the education front, we participated in 85
24 anti-fraud events since January of 2006, partnering
25 with non-profits, government agencies, trade groups

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1 and our lender customers to reach over 10,000 real
2 estate professionals.

3 Our goal with these outreach efforts is to
4 share information about fraud schemes, and to
5 collaborate broadly on prevention strategies.

6 In closing, please allow me again to
7 emphasize that mortgage fraud knows no favorite
8 product or pricing scheme. Perpetrators utilize
9 whatever products are available, and fabricate
10 whatever documentation they need to make deals work.

11 They exploit gaps in the mortgage process,
12 and when one gap closes, they find another.
13 Consequently, consumers must approach mortgage loan
14 applications responsibly and honestly, to avoid
15 becoming unwitting victims or conspirators.

16 All professionals involved in mortgage
17 processing must match the perpetrators' imagination
18 and creativity in order to skillfully prevent their
19 success. Whatever the Board can do to help will be
20 much appreciated. Thanks again for the opportunity to
21 participate. I look forward to learning and hearing
22 more from all the other speakers.

23 GOVERNOR KROSZNER: Thank you very much.
24 Now we'll hear from Susan Davis from Wells Fargo.

25 MS. DAVIS: Thank you. Before I start, I

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1 just want to say thanks for all you're doing on the
2 fraud front. That's just huge.

3 Good morning. I am Susan Davis, and I lead
4 the Consumer Real Estate Lending Activities for Wells
5 Fargo Home Mortgage. I would like to first address
6 the general questions the Board has asked, and given
7 the rapidly changing real estate lending environment,
8 Wells Fargo believes guidance is more appropriate than
9 rules, and existing and contemplated guidance should
10 be given the chance to work.

11 Any action taken by the Board should be
12 designed to create uniform standards that apply to all
13 lenders, including federal and state regulated lenders
14 and others.

15 You have asked whether specific terms or
16 practices should be regulated across the board, or
17 just for subprime lending. We believe that truly
18 unfair, deceptive and abusive practices should be
19 eliminated for all mortgage loans. We believe that
20 consumers, prime and subprime alike, should be
21 protected from unscrupulous and unregulated loan
22 originators who offer irresponsible loan products.

23 It is also important to note that the
24 specific loan terms and practices being examined by
25 the Board are not, by themselves, or in isolation,

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1 unfair, deceptive or abusive.

2 Lenders who adhere to responsible lending
3 principles can develop responsible loan products that
4 incorporate some of these loan terms for certain
5 customers.

6 At Wells Fargo, we have chosen not to make
7 pay option ARMs or loans with negative amortization.
8 The problem with the loan terms in question is that
9 irresponsible lenders, without a shared interest in
10 the long-term financial success of the consumer and
11 investor, can abuse each of these loan terms and
12 practices.

13 Next, I will address the Board's question on
14 specific loan terms or practices. With respect to
15 prepayment penalties, Wells Fargo believes that they
16 are useful and appropriate when provided in a
17 responsible fashion. Prepayment penalties allow
18 consumers who intend to stay in their homes for an
19 extended period of time the option of a lower interest
20 rate.

21 The existence of prepayment penalties has
22 also contributed to the liquidity of the secondary
23 markets, by assuring a minimum return to investors.
24 We agree that limiting the term of the prepayment
25 penalties to the initial fixed period of an adjustable

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1 rate loan, as Wells Fargo currently does, would be an
2 appropriate standard for the industry.

3 We agree that providing additional
4 disclosures about the nature of prepayment penalties
5 and the availability of loans without such terms would
6 also be appropriate. The consumer should also receive
7 a clear benefit, such as a reduced interest rate, if
8 she or he chooses a prepayment penalty.

9 On the topic of requiring escrows for
10 subprime loans, we believe lenders should clearly
11 disclose the absence or availability of escrows, and
12 regardless of the consumer's choice, should underwrite
13 the loan assuming the full amount of principal,
14 interest, taxes and insurance.

15 Regarding any restriction on stated or low
16 documentation loans, we believe these loans need to be
17 tied to bright line tests that can be consistently
18 documented. Several years ago, Wells Fargo
19 implemented such a bright line test when it chose to
20 eliminate the availability of stated income loan
21 products to all consumers whose FICO scores were below
22 620.

23 With respect to the affordability of credit,
24 there has been a great deal of discussion about how to
25 determine a borrower's ability to repay an ARM loan

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1 and at what rate and payment amount should be used in
2 underwriting an ARM.

3 The FFIEC, in its inter-agency guidance and
4 statements, has recommended that a fully indexed rate
5 be used, except in those cases where because of the
6 interest rate environment, another rate, such as a
7 fixed rate, may be more prudent.

8 Wells Fargo strongly believes that the
9 evaluation of a consumer's ability to repay an ARM
10 loan should be determined in accordance with the
11 inter-agency guidance.

12 Capping the debt to income ratio at 50
13 percent does both lenders and consumers a disservice,
14 as interest rates move up and down, new types of
15 mortgage products evolve, and the credit environment
16 changes. This is an area where guidance is more
17 appropriate than bright line rules.

18 The Board should avoid any rule-making that
19 unnecessarily limits availability of innovative
20 lending products, and it should allow the market to
21 make necessary corrections, and should not overreact
22 to the current wave of concerns.

23 In conclusion, the Board should focus on
24 creating a regimen of uniform consumer protection
25 requirements that consistently applies to both

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1 federally regulated lenders and others. Recognizing
2 the constantly changing mortgage environment, we urge
3 the Board and other agencies to maintain the ongoing
4 dialogue with mortgage market participants. Thank
5 you.

6 GOVERNOR KROSZNER: Thank you very much.
7 And now we're going to hear from Harry Dinham of the
8 National Association of Mortgage Brokers.

9 MR. DINHAM: Good morning. I am Harry
10 Dinham, President of the NAMB. We appreciate being
11 invited to participate in this morning's panel. We're
12 the only trade association devoted to representing the
13 mortgage broker industry. Our members are state-
14 regulated, independent, small business men and women,
15 that adhere to a strict code of ethics and best
16 lending practices.

17 Today, we have one of the strongest mortgage
18 financing delivery systems in the world. The
19 tremendous growth and development in the secondary
20 market has given lenders greater access to capital,
21 lower cost, diversified risk, and increased access to
22 credit for all consumers.

23 Credit scores, automated underwriting
24 models, and risk-based pricing have increased the
25 number of originators and therefore competition, which

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1 has decreased the relative cost of the non-prime
2 versus the prime.

3 Still, our success has not come without
4 problems, particularly in the non-prime variable rate
5 market. We walk a fine line if we craft measures to
6 address the problems in this market segment. We all
7 agree that we need to curb abusive lending practices,
8 but we must be careful not to advance measures that
9 will unintentionally harm consumers.

10 I want to clarify before discussing our
11 recommendations that we are not convinced HOEPA is the
12 best forum for many of the measures needed to address
13 the abusive lending practices effectively.

14 The intent of HOEPA was to prohibit
15 practices and provide a cooling-off period for
16 consumers of high cost loans. What needs to be
17 addressed today are the practices that are unfair,
18 deceptive and unethical. What we believe that it is a
19 leap to say the protections in HOEPA must be expanded,
20 irrelevant of the cost of loans.

21 With that in mind, NAMB recommends the
22 following best business practices for the industry.
23 NAMB believes regulators can establish and encourage
24 industry-driven best practices that address
25 professional standards, ethics and financial literacy.

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1 We are currently reviewing our best
2 practices, and are willing to work with regulators and
3 other industry representatives to ensure that there is
4 a uniform standard of best practices that applies to
5 everyone.

6 We also recommend that a uniform industry-
7 wide best practice that all mortgage originators
8 conduct their business and operate under a duty of
9 good faith and fair dealing. We do not need to wait
10 for laws and regulations to tell any of us to be
11 ethical, honest and not lie, cheat, steal or commit
12 fraud.

13 Secondly, effective disclosure is the best
14 defense against abusive lending practices. Some have
15 said there are too many pieces of paper now. We do
16 not need more. NAMB agrees, and we support
17 streamlining the mortgage process.

18 But with the new complex mortgages like
19 option ARMs, more disclosure, not less, is warranted.

20 NAMB proposes the creation and industry-wide use of a
21 one page payment disclosure, that communicates key
22 loan features and deters the prospect of payment
23 shock.

24 In addition, we encourage HUD and the Board
25 to update other key disclosures, such as the GFE and

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1 TIL statement.

2 Three, regulate the practices, not the
3 products. Abusive practices relate to people, not
4 products. We should remember that each consumer is
5 unique. Each one chooses a loan for his or her own
6 personal reasons.

7 What was inappropriate for some was perfect
8 for others. For this reason, NAMB does not believe in
9 prohibiting programs, products or loan features.
10 Instead, we support the creation of policies that will
11 prevent abusive practices in the market.

12 Since 2002, NAMB has called for the increase
13 in professional standards, educational requirements
14 and background checks for all originators. We remain
15 the only industry trade association calling for this
16 reform. In addition, NAMB believes mortgage
17 originators must have something to lose if they act
18 unethically.

19 Therefore, NAMB supports the creation of a
20 national registry for all mortgage originators, that
21 will prevent bad actors from moving within the
22 mortgage community.

23 Four is principle-based guidance. The
24 recent Supreme Court case, *Waters v. Wachovia*, has
25 split the mortgage industry into two camps: those

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1 subject to federal oversight versus subject to federal
2 and state oversight.

3 This split system has created gaps and
4 without appropriate oversight, two things will happen.

5 New business models will develop that exploit the
6 removal of state consumer protection laws for the
7 federal entities and their subsidiaries. There will
8 be confusion as to whether a similar level of consumer
9 protection can be afforded consumers of federally-
10 exempt entities.

11 The federal banking agencies currently do
12 not possess the infrastructure and resources needed to
13 respond to consumer complaints appropriately, and in a
14 timely manner.

15 In contrast, all 50 states have similar
16 elements of consumer protection. They also have well-
17 established processes for handling consumer
18 complaints, and for supervising and handling
19 individual licensed professionals who interact with
20 consumers.

21 To create uniformity, NAMB believes the
22 federal agencies should create principle-based
23 guidance and allocate funds for supervisory oversight,
24 in addition to delegating authority to the state
25 agencies currently providing consumer protections.

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1 Thank you.

2 GOVERNOR KROSZNER: Thank you very much.
3 Now we're going to turn to Martin Eakes, Center for
4 Responsible Lending.

5 MR. EAKES: Good morning. I'm the CEO of
6 Self Help, which is a community-developed lending
7 group based in North Carolina. For the past 26 years,
8 we've been making loans to minority and low income
9 families.

10 I say that we're one of the very earliest
11 subprime lenders. We didn't know it. We were just
12 helping people. Our loss rate on providing 55,000
13 homeowners \$5 billion in financing has been under a
14 half a percent each year. If you have large losses in
15 making subprime loans, it means you're doing something
16 wrong.

17 I'm also the CEO for the Center for
18 Responsible Lending, a non-profit research
19 organization dedicated to protecting home ownership
20 and family wealth by working to eliminate abusive
21 financial practices.

22 In November of last year, we issued a study
23 that noted the foreclosures that would occur over the
24 next few years. The two facts of note in that study
25 were number one, that one out of five borrowers who

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1 received a subprime loan during 2005 and 2006 would
2 lose their homes to foreclosure over the coming year.

3 That amounts to about 2.2 million families
4 either that have lost or will lose their homes because
5 of subprime loans. To put this in perspective,
6 Hurricane Katrina displaced 300,000 families.
7 Reckless and virtually unregulated subprime lending
8 has created a storm disaster that is at least seven to
9 ten times that magnitude.

10 But the storm in foreclosures is happening
11 silently all across the country, one home at a time,
12 in neighborhoods that are faceless and unseen all
13 across the country. This is particularly devastating
14 for communities and families of color.

15 Fifty-three percent of all African-American
16 loans made in the United States in 2005 to 2006 were
17 subprime. So basically we have two different systems
18 of lending. One for white borrowers, and one that
19 serves the majority of African-American and 40 percent
20 of all Latino borrowers.

21 Because of foreclosures and loss of equity
22 by persistent flipping of loans, it is likely over the
23 next four or five years we will see the greatest loss
24 of African-American and Latino home wealth that the
25 country has ever seen.

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1 Even in the midst of all of these
2 foreclosures, the market forces have really not reined
3 in abusive lending. If we go to a review of the
4 securitized loans, of subprime loans during the first
5 quarter of 2007, 80 percent were still the exploding
6 ARM loans, even in the first quarter of 2007, once the
7 problem had become so pronounced.

8 Seventy-two percent had prepayment
9 penalties; 43 percent were stated income loans. We
10 have this sense that the market has been correcting,
11 and yes, there has been some reduction in the investor
12 community.

13 But unfortunately, we have two different
14 markets. One is the investment market; the other is
15 the home ownership market. In the home ownership
16 market, there's no correction whatsoever. Families
17 are losing their homes; the level of correction is
18 happening too late.

19 I will say candidly that the Federal Reserve
20 bears some responsibility for this. Thirteen years
21 ago, Congress required that the Board prohibit
22 mortgage lending acts that are abusive, unfair and
23 deceptive. It wasn't a request; it wasn't a
24 discretionary action; it was a mandate that said the
25 Board will prohibit these actions.

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1 Seven years ago, I testified in a House
2 Committee that Chairman Leach was chairing, and
3 Chairman Leach said the following. He said "Congress
4 passed a law which was very strong in its sense and
5 purposes, the 1994 HOEPA, in outlawing predatory
6 lending.

7 In effect then, because Congress felt that
8 the subtleties of this were beyond Congress, we gave
9 to the federal regulators, most specifically the
10 Federal Reserve Board, the authority to make
11 definitions and to move in this direction."

12 So the question becomes, if there's a
13 problem out there, and Congress has given very strong
14 authority to regulators and to the Federal Reserve,
15 has and is the Federal Reserve AWOL?

16 I would suggest during the last seven years,
17 the Federal Reserve has made some small steps, but
18 they've been very insufficient. With this tsunami of
19 foreclosures and lost homes, the Federal Reserve has
20 not used this authority that was mandated at all
21 during these seven years.

22 Let's talk about some of the specific
23 problems. The ability to pay others will talk about.

24 I want to really focus on the escrows for taxes and
25 insurance, and on the prepayment penalties.

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1 The dominant practice in the marketplace in
2 subprime loans today is to focus solely on the monthly
3 payment. That's what companies market; that's what
4 consumers identify.

5 So if you have a responsible lender that has
6 a very good product, that's low cost, that would be
7 sustainable and not put a family in jeopardy of
8 foreclosure, they are in this terrible situation where
9 if they get marketed a product that says "I can give
10 you a 20 percent lower monthly payment because we
11 don't have an escrow for taxes and insurance."

12 It's a totally artificial market failure
13 that the Board could easily correct, by simply
14 requiring that escrows be collected for any subprime
15 mortgage loans.

16 On prepayment penalties, the problem with
17 prepayment penalties is that in the prime market,
18 where people really do have a choice, only two to four
19 percent of borrowers choose prepayment penalties.

20 In the subprime market, where borrowers
21 really are given a paper and said "Sign here," it's
22 somewhere near 70 percent of all borrowers are given
23 loans with prepayment penalties. You can't really
24 explain the difference between those two markets.
25 It's anti-competitive to have a prepayment penalty,

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1 and most subtly, the prepayment penalties are the glue
2 that enable racial steering to stay in place.

3 I'll come back to that if we have time in
4 the question and answer session.

5 Two other issues, just to throw out and I
6 won't talk about them, is that we need to deal with
7 the 60 percent of subprime loans in 2006 that were
8 made with second mortgages, where you have a 80
9 percent first and a 20 percent second, which makes it
10 impossible for borrowers to get out.

11 If you consider the affordability just for
12 the first loan and not the second, you've got a
13 problem.

14 Finally, we need to talk about mortgage
15 brokers. There is a problem there. Most of them are
16 good, but many of the mortgage brokers are simply a
17 license to put people in loans as quickly and as fast
18 as possible. Thank you.

19 GOVERNOR KROSZNER: Thank you very much.
20 Now we're going to hear from Ira Rheingold from the
21 National Association of Consumer Advocates. Is this
22 working? It sounds like it's working.

23 MR. RHEINGOLD: Good morning. My name is
24 Ira Rheingold. I'm the Executive Director and General
25 Counsel of the National Association of Consumer

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1 Advocates.

2 Our members are the consumer advocates
3 across this country, who on a daily basis speak with
4 and represent the consumers victimized by bad lending
5 practices, and see the very real life consequences of
6 an out of control subprime mortgage lending
7 marketplace.

8 I hope that at today's hearings, you will
9 hear their voices through me, and that after this
10 hearing you will begin to take the necessary actions
11 with systems development, of a rational subprime
12 mortgage market that actually serves the needs and
13 demands of consumers and communities across our great
14 land.

15 As my testimony is based on my personal
16 experience and the collective experience of consumer
17 advocates like me, I'd like to start by sharing a
18 little bit about my background.

19 Since graduating law school in 1986, I've
20 spent my legal career working in some of the poorest
21 rural and urban communities across our nation. I've
22 seen what it's like to live in a homeless shelter or a
23 rural shack without indoor plumbing, or one of the
24 toxic public housing projects that are a testimony to
25 our nation's failure to provide clean, affordable and

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1 safe housing to all our citizens.

2 I understand the dream and promise of home
3 ownership, of living in a safe and decent community
4 where the essential human need of successfully raising
5 a family can be met. Unfortunately, I've seen and now
6 understand how these dreams and that great promise can
7 be turned into a nightmare, when the needs and
8 aspirations of home owners are abused by all of the
9 players in the subprime mortgage marketplace.

10 In the mid-1990's, after I worked on health,
11 welfare and public rental housing issues, I began
12 running a foreclosure prevention project at the Legal
13 Assistance Foundation of Chicago. As I began that job
14 and I began meeting with homeowners, I was initially
15 shocked at the mortgage loan documents they would show
16 me.

17 Astronomical broker and lender fees;
18 incredibly high APRs. I'll never forget the first
19 FAMCO loan I saw. Ridiculous junk fees and included
20 credit life and credit disability insurance, and
21 absurd payments to unknown creditors and home repair
22 companies that never did any work.

23 I remember as it was yesterday, in my first
24 conversation with a mortgage lender, who explained to
25 me, in my ignorance and naivete, that all of these

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1 fees and charges, especially the credit insurance,
2 were absolutely necessary, were in the consumer's best
3 interest, and that any regulation that would limit
4 these fees or restrict interest rates would needlessly
5 cut off access to credit and the dream of home
6 ownership to my clients and the communities I cared
7 about.

8 I knew that argument was absurd then, as it
9 is even more so today, and that this has
10 unquestionably been proven over the past decade. Be
11 thankful you don't see credit insurance anymore. The
12 Fed deserves some credit for that, and we really see
13 loans that exceed the homeowner state legislative fee
14 and/or interest limits.

15 Yet no one can argue that the availability
16 of credit has done anything but explode, while these
17 necessary mortgage loan features have been mandated
18 away. Unfortunately, while these equity destroying
19 products have mostly left the mortgage market, the
20 subprime lending industry continues to adapt and
21 morph, creating more and better ways to exploit the
22 limited wealth of our nation's most vulnerable home
23 owners and borrowers, left all but unregulated over
24 the past dozen years as Congress and all the federal
25 regulators unthinkingly accepted the false mantra that

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1 regulation would cut off access to credit.

2 The subprime industry has created a
3 completely irrational marketplace, at least for
4 consumers. In place of an efficient market that
5 provides real consumer choice and rewards consumers
6 for smart credit decisions and rational aspirations,
7 we have a subprime mortgage market that has recklessly
8 created and sold ridiculously risky mortgage products
9 that have excessively benefitted all of the market
10 players at the expense of middle class and low income
11 homeowners and their communities.

12 While I fear that for many American
13 homeowners, any regulatory action is too late, I am
14 glad to see that the Federal Reserve is beginning to
15 ask the right questions, and I hope that this will
16 serve as the first step in taking corrective actions
17 to protect future homeowners.

18 While I hope during the course of this
19 hearing to expand on these thoughts and
20 recommendations, here are some of my initial thoughts
21 on what the Federal Reserve can and must do under the
22 authority granted to it by Congress under HOEPA.

23 First, require common sense underwriting.
24 One of the greatest absurdities in the current out of
25 control subprime mortgage marketplace is a consumer's

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1 true ability to repay the mortgage is often not
2 considered.

3 It is absolutely essential that the Federal
4 Reserve create regulations that force all mortgage
5 lenders and underwriters to make certain that a
6 borrower's repayment ability truly reflect the loan's
7 long-term affordability.

8 The Fed must also prohibit subprime mortgage
9 lenders from offering no document or stated income
10 forms. These loans are not only a license for a
11 mortgage originator to lie about a borrower's ability
12 to repay, but also allows them to charge a higher
13 interest rate than the borrower would otherwise have
14 to pay.

15 Prohibit deceptive practices that disguise
16 the real cost of a loan. In all of my experience
17 representing mortgage borrowers, I have never heard a
18 rational reason that benefits the consumer, for a
19 subprime refinance loan to not include taxes and
20 insurance in the borrower's mortgage payment.

21 I have, on the other hand, spoke with
22 countless borrowers, who were led to believe that
23 their new mortgage payment would be lower than their
24 existing mortgage, only to discover, often too late,
25 that the only reason the payment was lower is because

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1 taxes and insurance were not included.

2 The Fed must require taxes and insurance to
3 be included and disclosed as part of their future
4 monthly payment, in all of the prime loan documents.

5 Finally, establish effective consumer
6 remedies for unfair practices. The fundamental
7 failure of the subprime marketplace to act rationally
8 towards consumers is caused by the complete lack of
9 accountability between the myriad of actors in today's
10 mortgage industry.

11 I'll expand on that later, as we get to the
12 question and answer session.

13 GOVERNOR KROSZNER: Thank you very much.
14 Now we're going to hear from Janis Bowdler, from the
15 National Council of La Raza.

16 MS. BOWDLER: Thank you. Am I on? Hello?
17 Can you hear me? Is that better? Okay. Good
18 morning. My name is Janis Bowdler. I'm a senior
19 housing policy analyst for the National Council of La
20 Raza.

21 In my time there, I've published on fair
22 housing issues and predatory lending issues as they
23 affect the Latino community. I've also testified
24 before the House and Senate and participated in last
25 year's hearing before the Fed in Philadelphia. So I

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1 want to thank you for this invitation.

2 The number of Hispanic families entering the
3 mortgage market is going up every year. Hispanic home
4 ownership is at an all-time high, but unfortunately,
5 so is foreclosure.

6 For many of us that are here at the table,
7 though, this really isn't new news. This didn't come
8 as a surprise. NCLR has been warning for years that
9 lots of our Latino families were getting bad loans.

10 We think it's time to call it what it is.
11 The market is broken. Many Latino borrowers have
12 unique profiles. Thin credit files, multiple wage
13 earners per household, and these are characteristics
14 that prime lenders that thrive on automation don't
15 find very attractive.

16 Where prime lenders have neglected our
17 communities, subprime lenders have been quick to fill
18 the gap. Now, as you heard Martin say, 40 percent of
19 Latino loans are subprime.

20 Prime lending to minority families is in
21 disarray, and it's high time the Federal Reserve and
22 other regulatory agencies affirm that commitment that
23 fair lending and equal access to credit laws and
24 principles. All families should have access to
25 fairly-priced credit that is appropriate for their

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1 risk level.

2 It's sad to say, but I don't think that
3 that's where we're at now, and I think the Fed has an
4 opportunity to restore some balance to the
5 marketplace. In the interest of time, I'm going to
6 narrow my remarks to just a couple of areas, and then
7 expand it in question and answer.

8 So I'd like to talk about borrower's ability
9 to repay, some deceptive acts at pre- and post-
10 origination, and the fair advertising and minority
11 language publications.

12 I won't go into too much detail, since
13 ability to repay has already been covered. But I do
14 want to say that I think this is one of the most
15 important issues facing us now. Without an ability to
16 repay standard, underserved communities cannot rely on
17 home ownership to build wealth, which is the whole
18 reason that we promote home ownership in the first
19 place.

20 What our home ownership counselors tell us
21 is that over and over, the foreclosure clients that
22 they see have loans that they were never going to be
23 able to repay.

24 Now a large part of figuring out a
25 borrower's ability to repay is how you document their

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1 income. This is an issue that is very sensitive in
2 the Latino community. Thirty-five percent of Latinos
3 born in the U.S. do not have basic banking accounts.
4 That number goes up to 45 percent when you look at
5 immigrant communities, and many rely on cash income.

6 Our community is still struggling to connect
7 to products that are flexible and accommodating of
8 these unique characteristics. But at the same time,
9 stated income and low doc loans have been used to take
10 advantage of our families.

11 We need flexibility, but we also need
12 accountability. So we recommend that the Federal
13 Reserve require originators to use the best and most
14 appropriate document available when verifying income.

15 NCLR is also concerned about deceptive ads
16 targeting Latinos, and escrow was already talked about
17 a little bit. So I'm not going to go into that, but
18 I'd be happy to talk about that in Q and A.

19 What I do want to do is take some time to
20 pick up on something that Sandy actually talked about,
21 and I was really glad that they mentioned this, and
22 that is what we're seeing as an uptick in foreclosure
23 rescue scams.

24 Since I'm a big fan of visual aids, I have a
25 stack of solicitations here that are sent to Latinos

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1 in financial crisis at the time of foreclose that I'd
2 be happy to share with you.

3 As you heard described, so-called
4 foreclosure consultants call. Families think that
5 they're getting refinanced, and actually they've been
6 tricked into handing over the deed to their house.
7 Which means they lose the opportunity to do
8 mitigation, and they lose the opportunity to sell
9 their home.

10 We think that one way to get at this would
11 be to call this what it is, which is an extension of
12 credit under TILA and HOEPA, and that might get at
13 some of these issues.

14 One last issue that I want to bring your
15 attention to is we are concerned that little attention
16 is being paid to mortgage advertisements in Spanish
17 language press. Latinos and other immigrants and
18 language minorities turn to ethnic press to find
19 practitioners that speak their language, and who they
20 believe will be more understanding of their credit
21 needs, the unique borrower profiles that I described
22 earlier.

23 I also have a stack of newspapers here from
24 this weekend, I come prepared. In looking through the
25 papers, I couldn't find one broker advertised loan in

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1 the English paper. In the Spanish paper, I couldn't
2 find one traditional product, and I couldn't find one
3 TILA disclosure available on that.

4 While we don't think that disclosures are by
5 any means the answer to what we have going on here,
6 fairness in advertising is an important part of
7 ensuring equal access to credit available to all
8 borrowers.

9 We know that where you enter the mortgage
10 market does predict reasonably what kind of product
11 you're going to end up with. So we'd like to
12 recommend that this should be investigated by
13 oversight agencies, as high as DOJ and the Fed, and
14 we'd also like to see that the Board declare
15 misleading advertisements by third parties as a
16 deceptive act and practice.

17 With that, I will wrap up, and I will be
18 happy to answer or expand on anything in Q and A.

19 GOVERNOR KROSZNER: Thank you very much.
20 Finally, we're going to hear from Alys Cohen from the
21 National Consumer Law center.

22 MS. COHEN: Thank you. Can people hear me?
23 Thank you for having the National Consumer Law Center
24 here today. My name is Alys Cohen. I'm a staff
25 attorney at NCLC. I've been working on predatory

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1 lending issues for more than ten years.

2 I'm sorry to say that from day one,
3 consumers have been calling me about the loans they
4 can't afford, and they continue to call me today.
5 Lawyers who work with Ira and others call up and send
6 us the loan documents.

7 The only thing that has changed really is
8 the details. But basically, this has been going on
9 for a long time, and for a long time, government
10 officials have been hearing about it. We hope that
11 finally, serious action can be taken, because nibbling
12 around the edges is not going to solve this problem.

13 This is about wealth-building, and the cost
14 of not acting is a lot bigger than the cost of acting.

15 What we've seen to date is rhetoric about access to
16 credit when what we really see is access to borrowers
17 by predatory lenders.

18 We want access to credit too. We want
19 access to good and fair credit for everybody. What
20 we're seeing is an epidemic of damaging loans,
21 primarily refinancings in the subprime market, and
22 there's been a lot of focus on the resets that we're
23 seeing for hybrid ARMs.

24 But I'd like to also focus you on another
25 problem. Some preliminary data from the Mortgage

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1 Project, which is an analysis of bankruptcy data for
2 homeowners by Catherine Porter and Tara Tummey, and
3 they wanted me to tell you it's preliminary data,
4 shows that 60 percent of ARMs that fail are pre-reset,
5 and that over half of the pool of failed loans are
6 fixed rate loans.

7 So we have a reset problem, but we have a
8 very broad problem that we really need to take a look
9 at. Moreover, the cost to real people here is very
10 serious. There's the cost of losing your home if it's
11 the only wealth you have, and in most communities of
12 color that's all there is.

13 Then there's the question of when you get
14 back into your home. When can you get this wealth
15 again? For white homeowners, it's over ten years, and
16 for African-American and Latino homeowners, it's 30 to
17 40 percent longer than that.

18 So the costs we're talking about are very
19 high, and we'd like to take the risk that's solely on
20 the backs of these folks and distribute it more
21 equitably between industry and borrowers instead.

22 The National Consumer Law Center would like
23 to make several recommendations. I'll be brief and
24 then we can go into it more in discussion. Did you
25 just ring a bell?

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1 GOVERNOR KROSZNER: No.

2 (Laughter.)

3 MS. COHEN: Thank you, Leonard. As you've
4 heard before, the biggest problem is people can't
5 afford their loans. So we believe it's incumbent upon
6 the Federal Reserve to act and to prohibit loans that
7 are unaffordable by requiring an analysis of ability
8 to repay.

9 For us, this doesn't only include a debt to
10 income ratio consideration; it also includes looking
11 at residual income, because poor people need enough
12 money. They don't just need a percentage.

13 It also means including taxes and insurance
14 in the analysis, whether or not it's escrowed,
15 although we believe it should be escrowed and that
16 should be mandatory.

17 The question is whether fully-indexed rate
18 is the right analysis of ability to repay. We believe
19 that goes a long way. We believe it doesn't go far
20 enough. There are people whose initial rates are
21 higher than the fully indexed rate, and many people
22 who never pay the fully-indexed rate. They pay a lot
23 more.

24 The question is, are we going to leave those
25 people out in the cold? You need to make loans

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1 affordable not just when they're made, but throughout
2 the life of a loan. That means forced placed
3 insurance that's provided by services should be
4 illegal unless the homeowner has been denied insurance
5 for a reason other than non-payment.

6 If the servicer can provide forced placed
7 insurance, they can provide affordable homeowners
8 insurance to their borrowers.

9 Loss mitigation is also necessary to keep a
10 loan affordable, and to keep someone in their home.
11 Right now, servicers may or may not provide full
12 access to loss mitigation, and it's really a coin toss
13 for the borrower.

14 We believe loss mitigation should be
15 required before foreclosure is pursued. When the
16 loans are made, the best and most appropriate form of
17 documentation should be provided. I want to be clear:
18 self-employed people should not be excepted from
19 this. I see loans regularly for self-employed people.
20 They are some of the biggest victims of abuse.

21 If you can find an alternative means of
22 credit scoring people, you can find an alternative
23 means of actually evaluating the ability to repay for
24 people who are self-employed.

25 Two last ones. One is we believe the

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1 Federal Reserve Board should adopt a general
2 unfairness and deception standard that can apply
3 across America, to homeowners who are facing
4 foreclosure.

5 Right now, we rely on government officials,
6 and the truth is, they can't be everywhere and they're
7 not everywhere. In addition, there are state laws,
8 but they don't apply in every state. In Virginia, if
9 you are going to lose your house, and the bankers
10 haven't stepped in and the bank regulators haven't
11 stepped in, you cannot protect yourself with a state
12 unfairness or deception standard. We think we need to
13 have a federal one.

14 Finally, there are certain terms that need
15 to be limited. Prepayment penalties and also discount
16 points. Discount points are only appropriate when you
17 get a discount. I've never seen a discount point in
18 the subprime market that was associated with a
19 discount in the rate. I'd like to see that.

20 In addition to discount points, we believe,
21 should not be charged when there's a yield spread
22 premium. We can talk about that more in comments.
23 Finally, I just want to say communities across
24 American are bleeding. They may not be your next door
25 neighbors, but it's happening. If we don't fix it,

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1 we're never going to be able to. Thank you.

2 GOVERNOR KROSZNER: Well, thank you very
3 much. I thank all the panelists for excellent
4 presentations and also presentations that kept within
5 the time limit, because now we get to the particularly
6 interesting part, when we get to the posed questions.

7 I'm very pleased that the panel has touched
8 on the four key issues that I had wanted to discuss,
9 plus a number of others. So why don't we start with
10 one of the issues that quite a few of you raised,
11 about escrow for taxes and insurance.

12 So I've heard discussions on both sides
13 about the importance of including that, and whether a
14 rule could be fashioned that would be helpful to
15 provide that. So I want to hear from different
16 panelists about what they think about the importance
17 of taxes and insurance, having the escrow for that
18 included, or having a provision for that included.

19 If we were to consider a rule in that area,
20 how, if at all possible, to craft one that would allow
21 for that, but not somehow exclude responsible subprime
22 borrowing. Whoever wants to start with that?

23 MR. RHEINGOLD: I'm happy to start. I think
24 that any rule -- I mean my personal view is that you
25 have to require taxes and insurance. I think it has

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1 to be required for all subprime loans.

2 I think one of the things -- and talking to
3 economists, we all understand that when people shop,
4 the most important fact for people is what is their
5 monthly payment going to be?

6 In my view, the lack of inclusion of taxes
7 and insurance on that payment has everything to do
8 with telling people that your next payment, your
9 refinance loan is going to be lower than your existing
10 payment. It's all about hiding what the real payment
11 of that loan is.

12 I think that it leads to all sorts of
13 problems. We're talking about the subprime market.
14 We're talking about people with less liquidity, with
15 more credit problems, with less financial savvy. I
16 think making sure that taxes and insurance are
17 included will one, prevent sort of that shock; will
18 stop, will prevent hiding the real cost of that loan;
19 and also sort of go a long way to preventing some of
20 the other problems that exist along the way because of
21 non-payment of taxes, where I've seen people lose
22 their houses because of non-payment of taxes, or the
23 forced place insurance that Alys talked about, that
24 it's just sort of an incredibly costly thing that has
25 hurt a lot of homeowners as well.

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1 GOVERNOR KROSZNER: Yes, Faith.

2 MS. SCHWARTZ: We actually -- we agree, in
3 the sense that we believe a loan with escrow is a much
4 better loan than a loan without escrow. We've worked
5 very hard to get them on the front end of the market,
6 but as Ira noted, you know, marketing in a market, to
7 try to transform it one lender at a time, it's pretty
8 difficult to do, although escrows have improved in
9 percentage considerably since over the last five to
10 eight years.

11 Our performance clearly shows it's better to
12 have an escrow loan. So we think there are ways the
13 Fed can influence the market, to guidance, to offer an
14 opt-out of escrows, not an opt-in. Almost that it is
15 a package of you should require escrowing.

16 I know what we do on the back end. We've
17 worked with the National Fair Housing Alliance for
18 years on this. We have an innovative pilot on the
19 back end to put them on as soon as those loans got
20 loaded into servicing. We have a website, we have
21 outbound calls to escrow mortgages and it has improved
22 our percentage of escrowing.

23 But at the end of the day, there are reasons
24 some people don't want to escrow. I don't know why
25 others wouldn't, but not everyone is always a cash-

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1 strapped borrower. In fact, it's a mix of borrowers
2 in the broad business.

3 So I think there probably are people who
4 don't escrow for some reason. So I guess the key is
5 if they have to opt-out, you'll get a much higher
6 influence, and the Board should probably recommend
7 escrowing in the subprime market.

8 You'd see more consistency, better loan
9 performance and I don't know many lenders -- I can't
10 speak for the lenders and I don't. But we would be
11 pleased to have escrows on our loans, at a higher
12 percentage than we do see.

13 MS. BRAUNSTEIN: But would you be pleased if
14 it was required for subprime loans?

15 MS. SCHWARTZ: Well, I believe in guidance.
16 Again, I think there's some choice that has to be
17 there. I don't know that you should tell everyone
18 they have to escrow. I wouldn't want to be told to
19 escrow if I don't want to escrow.

20 How do you know I'm not a subprime borrower?
21 There you go. I think we should encourage and
22 influence and improve the market performance.

23 GOVERNOR KROSZNER: So let me hear from one
24 of the lenders. You said let's hear from one of the
25 lenders.

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1 MR. SANCHEZ: What I would say is we
2 absolutely have to require the taxes and insurance to
3 be calculated in the monthly payment. In fact, we
4 believe that escrow should be offered 100 percent of
5 the time to the non-prime borrowers.

6 But requiring it, making it mandatory only
7 for that first time home buyer, that hasn't had the
8 experience of having taxes and insurance and escrow.
9 So we think it's absolutely the right thing to
10 pinpoint it at the first time home buyer, to make sure
11 that we take care of it.

12 I think one of the challenges in the whole
13 escrow, today we do it in the prime space all of the
14 time. But we also have many times have a cash-
15 strapped borrower, who in order to start the
16 traditional escrow they don't have the funds to do
17 that.

18 So we've been talking about is there a way
19 that we can help to fund for that escrow in the
20 beginning, because it's great to say "Well, you have
21 to escrow, and you know have to bring \$800 to the
22 closing table in order to start your escrow." Many of
23 those folks don't have it.

24 So requiring it, I think, for everyone,
25 really puts a limit on who has the ability to do that.

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1 MS. BRAUNSTEIN: Someone else?

2 MS. BOWDLER: Yes. I would just like to say
3 that, you know, we're kind of talking about what
4 happens when people have the choice of escrow and they
5 don't take it, or maybe they weren't offered escrow.

6 But we've seen, especially in Southern
7 California and a few other places, where this is
8 actually an outright fraud, not just to be more
9 competitive in artificially lower payments.

10 But if you can get somebody to take a loan
11 that doesn't have taxes and insurance and you know
12 that they're going to be shocked in a few months with,
13 you know, a couple of thousand dollar tax bill, then
14 who does it come back to? They come back to whoever
15 their originator was, looking for some help, and now
16 they're in a refinance cycle.

17 So we've actually seen it as a tool for
18 bringing business back to an originator, and stripping
19 out more equity with fees. So we are in favor of
20 requiring escrow to -- and tying it to something very
21 specific, subprime, high LTVs or otherwise cash-
22 strapped borrowers.

23 MR. CHANIN: Let me follow up on just the
24 lenders. In terms of escrowing, what your practice is
25 for Alt-A as well as prime loans; that is, what in

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1 terms of the data and the number and percentage of
2 people that escrow? Do you require it for those? Do
3 you strongly encourage it and so forth? Is there a
4 difference between your practices for subprime and
5 non-subprime? Maybe Susan, if you have any thoughts
6 on that.

7 MS. DAVIS: No. No difference between prime
8 and non-prime.

9 GOVERNOR KROSZNER: I'm not sure people can
10 hear you.

11 MS. DAVIS: Can you hear me? Hello? Okay.
12 No, not in terms of what the policy is in terms of
13 escrows are offered, as opposed to a choice.

14 The one thing I just want to draw a
15 correlation here is as I'm listening to everybody
16 speak, it's dawned on me that there's a very strong
17 correlation about ability to pay and the escrow issue.

18 So to me, it's absolutely critical that that
19 is included in the underwriting calculation of
20 principal, interest and taxes and insurance, that
21 you're actually looking at all of that.

22 I think that may solve some of it. I am
23 also doing a small test here to see should we look at
24 requiring it at certain LTVs for higher risk loans,
25 etcetera.

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1 My results are preliminary data that I have
2 actually been looking at before we launched this.
3 We're working towards it. Did not reflect the gain,
4 which then told me that a lot of the benefit is really
5 looking at the ability to pay.

6 If you can pay the taxes, that's critical.
7 So I actually put more emphasis on the ability to pay
8 and linking principal and interest, taxes and
9 insurance in your underwriting, as opposed to a
10 separate escrow, although as I said, I am working on
11 looking for some modeling there.

12 GOVERNOR KROSZNER: Yes, Harry?

13 MR. DINHAM: Well, you know, I've been in
14 this business almost 40 years, and as long as I've
15 known Fannie Mae and Freddie Mac have always required
16 escrow on loans that are over 80 percent LTV. I think
17 that's a good place to start.

18 Another way to look at this would be, you
19 know, some people have compared FHA loans to subprime
20 loans, and no matter what your LTV is on that, you
21 have to have escrows.

22 I think that we need to really look at the
23 fact that these people don't have the ability to pay
24 their bills on time, and for us to think that we can
25 put them out there in this home and maybe look at a

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1 two or three thousand dollar tax bill at the end of
2 the day, is a good thing. I don't think that's a good
3 thing.

4 I think we need to do some type of guidance
5 that's going to help us get it at least to the -- if
6 they're making loans over 80 percent LTV, loan to
7 value, that they need to have the ability to have
8 escrow accounts. So I think that's where we need to
9 go.

10 MS. DAVIS: Can I just make one other -- oh
11 Martin, if you want to comment.

12 MR. EAKES: Yes. I want to just add two
13 things. Fannie Mae and Freddie Mac require escrows on
14 any loan above 80 percent, because that's a measure of
15 risk. I would posit that every single subprime loan
16 has a higher level of risk than an 81 percent LTV
17 prime loan.

18 The second thing I would say is guidance
19 will not work here, and voluntary will not work here.

20 You can't have it both ways. Guidance is most
21 effective when you are a bank regulator that has
22 supervision over the entities.

23 If you want it to apply to all lenders,
24 which it must, if it doesn't apply to all lenders,
25 then the lenders who can offer non-escrow will win in

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1 the marketplace, because it is deceptive and borrowers
2 will be told you have a monthly payment that's 20
3 percent lower than the responsible lender next door.

4 This is one of those ones where you have to
5 go ahead and just have a simple required rule, bright
6 line across the board for everyone. I have had the
7 majority of subprime lenders that I have talked to,
8 who have told me we would like to have that as a
9 bright line requirement. We just can't be the first
10 actor and act unilaterally, or we will have zero
11 volume in the next year.

12 MS. BRAUNSTEIN: Would increased and better
13 disclosures help with escrows?

14 MR. EAKES: Disclosures are roughly five
15 percent of the solution to the problem. When you have
16 50 percent of the population, as reported by GAO, that
17 read at the 8th grade level of less, and 23 percent of
18 adult Americans who are illiterate, you cannot through
19 disclosure solve this problem.

20 You need to have as little intrusive across-
21 the-board rules as you can. But you know, we can't
22 solve this problem with Disclosure.

23 MS. BRAUNSTEIN: Well, one of the issues
24 that we're facing in trying to look at all of these
25 issues and structure rules, is that there are some

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1 well-established precedents for what the
2 characteristics are of unfair and deceptive acts and
3 practices, even though it's well-established in the
4 FTC Act.

5 So trying to associate some of these
6 practices with those criteria is not an easy task. So
7 I was wondering if you have any guidance for us, in
8 terms of in particular we'll want to talk about this
9 with all the practices, like for escrows.

10 MR. RHEINGOLD: I think that lack -- I think
11 that was my initial point. It's fundamentally unfair
12 not to include escrow, because that -- because the
13 lack of escrow has been used as a deceptive practice
14 to hide the real cost of mortgages for a lot of people
15 in the subprime mortgage market.

16 MR. EAKES: I mean the FTC definition of
17 deceptive, if we use that prong --

18 MS. BRAUNSTEIN: Right.

19 MR. EAKES: Remember, the standard here is
20 unfair or deceptive. It doesn't have to be both, but
21 either/or. So for deceptive, a practice is deceptive
22 if it is likely to mislead reasonable consumers, and
23 the misleading representation is material.

24 Well, I think we see the entire market
25 failure here, because of responsible lenders not being

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1 able to compete, and borrowers don't understand that
2 this is the cost, or they wouldn't fall into the trap
3 of saying this is really a 20 percent less expensive
4 loan when it really is not.

5 So it's squarely within the deceptive
6 language, even of precedent. I would argue that you
7 have more mandate than that, that the FTC Section 5
8 was in place from '75 on.

9 Congress saw fit in 1994. So in 1994, we
10 still had this problem of predatory mortgage lending,
11 and they went further. They didn't say -- because you
12 already had the authority to prohibit unfair or
13 deceptive under the FTC.

14 But they went further, saying we need
15 something more than that, and we empower the Fed to
16 have independent mandate and authority for mortgage
17 loans in particular, to prohibit abuses and unfair or
18 deceptive.

19 I would suggest that that takes you and
20 gives you strength and authority beyond what the FTC
21 standards are if you needed that.

22 MS. BRAUNSTEIN: One of the main things that
23 gave us was the ability to affect rules for all
24 mortgage transactions, whereas you know, with the FTC
25 Act, you know, we have the ability to affect rules for

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1 banks and those other entities.

2 MR. EAKES: But between you and the FTC,
3 you've had the authority to cover both banks and non-
4 banks. Congress still in 1994, because the problem
5 was so severe then, and it's only a fraction then of
6 what it is now, that they put this authority and
7 mandate to the Fed, of saying "We need you to have
8 something extraordinary, because homes are an
9 extraordinary piece of the American economy, an
10 extraordinary piece of families' well-being and
11 wealth."

12 So I think, you know, I'm sorry I sound
13 shrill and impatient, but I've been making this
14 testimony in the House and the Senate for almost ten
15 years now. So please, find the will --

16 MR. CHANIN: Let's assume, that as Susan's
17 guessed, that lenders underwrite a mortgage based on
18 not only principal and interest but taxes and
19 insurance; that is, in terms of underwriting.

20 So the question is then if you mandate
21 escrow, would you create any ability of the consumer,
22 for example, to opt-out, to deal with, for example,
23 Pablo's suggestion of a consumer -- what if a consumer
24 simply does not have the two months of taxes and
25 insurance to bring to the table? Is that consumer

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1 simply out of luck if the consumer doesn't have the
2 ability to escrow those funds, and cannot get the
3 loan? Is that an outcome that is satisfactory to you?

4 MR. EAKES: The opting out won't work.
5 Someone will have a form that lets you opt out, and
6 everyone will sign it for that lender, and they'll
7 start to dominate the market.

8 If a borrower is lacking only two months of
9 escrow, compared to the closing costs of getting into
10 a loan, which is often eight to ten percent of the
11 loan amount in total, that two months of escrow is not
12 going to be the marginal difference. Maybe the
13 lender, and I think the person from Chase may have
14 been suggesting, is maybe you can build that into the
15 loan.

16 I mean you can have some of the loan amount
17 cover closing costs and cover escrow. But ultimately,
18 if that's what's going to keep you out of a home, you
19 need to wait six more months before you become a
20 homeowner.

21 GOVERNOR KROSZNER: I just want to go back
22 to Pablo on that, because that was an interesting
23 suggestion that you had made, that Martin has picked
24 up on. Is there a way to integrate this -- these
25 other costs and fees in, to make sure that the person

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1 will be able to afford the full cost they'll be
2 facing?

3 MR. SANCHEZ: Well, that's what we're
4 talking about and working on right now, because we
5 really feel that that is a barrier. It's not just the
6 two months. It's the two months on top of the other
7 costs, right, that really people struggle with.

8 I think beyond that, we have to realize
9 that, I think everybody probably in this room knows
10 someone that's had a life event or a hiccup in their
11 life, that wasn't someone that was illiterate or
12 really down and out economically, right? It was there
13 in the subprime space because something happened, and
14 they have the ability to do these things.

15 So we've got to make sure that we're
16 understanding all of the consumers in this space. But
17 I think it's prudent for us to make sure that we offer
18 it, number one, across the board. I think what we're
19 talking about here is there are folks that don't offer
20 it all, and mark it solely payment, and they have a
21 competitive advantage, right, because they do that.

22 But if we mandate the fact that we have to
23 offer it, that we as prudent lenders understand when
24 it is appropriate for someone to have the ability to
25 opt in and opt out, I think that's reasonable.

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1 GOVERNOR KROSZNER: I just wanted to say
2 when you said -- what you mean by "it." So what do
3 you mean by "it" and exactly what do you mean by
4 opting out of it? Then we'll go back to --

5 MR. SANCHEZ: Well, offering the escrow;
6 mandating it for a certain portion of customers,
7 especially that first time home buyer. I think it's
8 very important, because they generally don't
9 understand how all of this stuff works.

10 GOVERNOR KROSZNER: So for a first time home
11 buyer, you would suggest a mandate, not an opt -- with
12 no opt-out?

13 MR. SANCHEZ: That's correct.

14 GOVERNOR KROSZNER: But for others who may
15 have had experience with owning homes before, you
16 would allow for the opt-out?

17 MR. SANCHEZ: I would allow for the opt-out,
18 yes.

19 MS. BOWDLER: So I was going to comment on -
20 - oh yes. Okay, I remember. I just wanted to echo
21 comments I agree, and the opt-in, the opt-out,
22 everybody -- I mean the stack of papers and the
23 signing and it's here, one more thing.

24 People -- I mean that's why we think that
25 disclosures aren't an effective way to regulate the

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1 market, because they are not an effective way to
2 communicate actual risks or decisions to consumers at
3 the closing table, which is the time when people are
4 least likely to say "Whoa, whoa, whoa, stop the
5 train."

6 I mean they've already got their boxes
7 packed and everything. So I don't think that's a good
8 idea. In terms of talking about the financial savvy
9 of consumers and their ability to determine their cash
10 flow, because that's really what you're talking about.

11 If you're going -- if somebody's going to decide that
12 they don't want to escrow taxes and insurance, it's
13 because they want to cash flow their money somehow.

14 Well wait. If we look at the prime market,
15 where you have arguably more savvy consumers with
16 higher credit scores, escrow's virtually universal.
17 So when dealing with, again I would point to high LTVs
18 and cash-strapped borrowers, this is where it's even
19 more important, because if they can't make it up
20 front, are we really -- can we reasonably assume that
21 in six months they will have come up with the \$3,000?

22 MS. COHEN: I have a couple of things I'd
23 like to add. On this question about what do you do
24 with the person with the hiccup, who finds themselves
25 in the subprime market?

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1 I mean what we're really talking about here,
2 and this is going to come up in a variety of other
3 topics is the rhetoric of freedom. To what extent is
4 an upper middle class person's freedom needing to be
5 unrestrained at the expense of someone who can't
6 otherwise protect themselves?

7 So what we're talking about here is
8 requiring some limited number of people who may not
9 need it to follow a rule, so that huge numbers of
10 people aren't gutted. So to me, that's weighing one
11 against the other, and it's very clear what the answer
12 is. Obviously, from the way I answered the question.

13 (Laughter.)

14 MS. COHEN: But I think that that's what
15 it's about. It's not about just helping those few
16 people remain unrestrained. It's about what is the
17 cost of not restraining those people.

18 I want to get back to Sandy's question about
19 the FTC unfairness standard and how it applies to
20 these various questions.

21 I agree with Martin, that providing a
22 monthly payment that doesn't include taxes and
23 insurance is deceptive. But it's also unfair, because
24 the unfair standard at the FTC is about whether or not
25 it's reasonably avoidable by the consumer.

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1 It's not reasonably avoidable on the part of
2 a subprime consumer, to end up in a hole because of
3 the practice of the lender. Over and over again, I
4 think, you can apply either the deception test or the
5 unfairness test, and you're going to end up in that
6 same situation.

7 But what it requires is looking at the
8 consumer and the shoes they're actually standing in,
9 not the shoes that the median consumer is standing in,
10 but the median subprime consumer is standing in.
11 By the way, NCLC has seen too many prime loans that
12 are abusive.

13 So I'm not saying we should only regulate
14 the subprime market, that a lot of these practices
15 that we're talking about, you ought to start focusing
16 on that. So I want to just raise that issue. To me,
17 unfairness or deception, you can meet either standard
18 and it's not that hard, unfortunately.

19 MR. CHANIN: Alys, let me follow up, and
20 I'll have to borrow the bell. I'll retract my other -
21 - no. So as we look at this question of escrow,
22 presumably it's certainly less of an issue or a
23 problem in the prime market.

24 So part of the question, as we explore this,
25 is how you would define the types of consumers, the

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1 types of products, etcetera, that any notion of
2 mandating an escrow would apply to?

3 Earlier, we've heard that you couldn't or
4 shouldn't do it by product, because the market's going
5 to develop. There will be new products and so forth.

6 So what is the standard that might be used in terms
7 of defining the scope of this?

8 MS. COHEN: Are you asking me that?

9 MR. CHANIN: Anyone in the --

10 (Laughter; simultaneous discussion.)

11 MR. CHANIN: You or anyone else.

12 MR. EAKES: It needs to be bright-lined,
13 because under the HOEPA standard, there is liability.

14 There is private action liability. So you don't want
15 to have a vague standard that someone trips into.

16 The two most obvious that jump out as
17 definitions to me that are bright line is use the HMDA
18 rate spread, which says 300 basis points above
19 comparable Treasury. I would argue a little bit about
20 what comparable Treasury should be in an ARM loan that
21 resets every six months, that perhaps comparable
22 Treasury should be the shortest reset period, not the
23 30-year Treasury.

24 Or, if you wanted to make sure that you
25 didn't have distortions, which I think we see whenever

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1 there is a Russian meltdown in '98, where you have
2 Treasuries become artificially low, you may not want
3 to tie it to Treasuries, because then you will start
4 capturing loans that are maybe not subprime at all in
5 the market.

6 So the historical standard is the Freddie
7 Mac contract rate plus 150 basis points, is equal to
8 the Treasury plus 300. But it would then have the
9 advantage that it would be insulated from the
10 distortions in Treasury over time.

11 I would use it based on APR, something that
12 says if it's a higher cost, someone has made a
13 decision that this a higher risk loan, which is the
14 justification for having a higher APR.

15 Have it be absolutely bright line, because
16 the last thing you want is people who get, you know,
17 who don't think they're making subprime loans, and all
18 of a sudden have loans that are 60 percent LTV but
19 trigger the subprime. We want it to be bright line

20 GOVERNOR KROSZNER: I want to hear from you
21 guys. How would something like that work in practice?

22 So let's take Martin's proposal. Is something like
23 that workable? Where do you see the potential
24 problems of that, the so-called unintended
25 consequences that we worry about?

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1 MR. BREWSTER: Well, I can speak to part of
2 that. One of the things we haven't talked about is
3 even though it's been mentioned again and again,
4 generally requires escrow, this is true, there's still
5 the possibility of that even if you require the
6 escrow.

7 So it's not just the -- who gets the escrow,
8 but also how the escrow is calculated. Some of the
9 escrow rules, as far as whether you require the escrow
10 or not, all that's simple. So some of the stated
11 restrictions are out there. So a lender could, even
12 escrowing, could wind up escrowing much less,
13 especially for a new construction loan.

14 That's where we see a lot of the issues,
15 because taxes haven't been established yet. Taxes are
16 reset then a year later, and all of the sudden your
17 taxes are \$6,000 a year, and you've only escrowed for
18 a thousand.

19 So now you've got a shortage and it sends
20 you into foreclosure. So not only is the eligibility
21 bright line standard important, but also I think the
22 standard of how to calculate the escrow, and making
23 sure it's sufficient for what the taxes will be.

24 GOVERNOR KROSZNER: But I want to hear
25 about, you know, some of -- the kind of proposal that

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1 Martin has put on the table. What do you see as being
2 the challenges if it were to be a rule, to try to
3 fashion this with all this you just said as part of
4 it?

5 Would that help to provide sort of a level
6 playing field for the marketplace, or do you think it
7 would have the consequence of perhaps excluding
8 borrowers who otherwise would be able to get loans ,
9 but there would be unintended spillover effects.

10 MS. SCHWARTZ: I think it's a workable
11 option to have bright lines. I think no one wants
12 inadvertent problems because they thought they made a
13 loan that was a prime loan and fell into a high cost,
14 something that's spread over a certain period,
15 whatever that might be.

16 So I think whatever you come up, that makes
17 sure that the majority of the market ends up
18 escrowing, is a net positive. I just -- I believe you
19 can do more than people think you can, because I've
20 seen it. The market has changed, it has reacted.
21 We've done it with the non-traditional.

22 Be thoughtful about it, because if you craft
23 it correctly, and maybe you're very clear about pieces
24 of that guidance, what should be escrowed, I think
25 you'll see a transformation on the escrow issue

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1 without inadvertent spillover into a very costly
2 situation if the lender -

3 GOVERNOR KROSZNER: Can we just pursue it a
4 little bit more, because I want to think about it,
5 especially as we think about having -- obviously, we
6 think about the rules versus guidance.

7 Where would be some of the stress points or
8 lack of clarity that could lead to people pulling out
9 of a market, say responsible lenders pulling out of a
10 market, because of concerns of triggering some
11 regulatory action?

12 MS. SCHWARTZ: I mean I think you either
13 escrow or don't escrow, and a bright line test on that
14 is a very reasonable suggestion. I mean I don't worry
15 about that as a lender. I know people who will worry.

16 So there are issues that could be a lot more
17 vague, that would cause concerns for liquidity and a
18 lot of those other factors. But this one is not as
19 complicated. I think all loans can be underwritten to
20 take into account the impact of taxes and insurance.
21 If they can't afford the loan, it shouldn't be made to
22 them.

23 MR. EAKES: Everything that is put into this
24 requirement, you have two additional prime lenders
25 that cannot be taken out, because they are not willing

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1 to do what they know are unsustainable non-escrow
2 funds.

3 GOVERNOR KROSZNER: Any other comments on
4 this, this issue?

5 MS. COHEN: I just want to respond to
6 Faith's comments about preferring guidance. It's
7 clear that there's been a sea change because of the
8 proposed and implemented guidance.

9 I want to go back to the comment that we
10 said earlier about credit insurance. When I got
11 started on predatory lending, that was a really big
12 headline. But the truth is, people are still charged
13 credit insurance. When they are, they can protect
14 themselves because there are rules that they can
15 enforce with regard to credit insurance.

16 But if it's guidance, not only does it not
17 apply to all the lenders, but a borrower who ends up
18 in an experience where the rule was violated in the
19 guidance, but there's no rule that applies to the
20 homeowner, you know, they're stuck.

21 So I would like to see market change. I'm
22 happy to see market correction. But we also have to
23 help the actual people who are suffering, and there's
24 really no way to do that without a rule.

25 GOVERNOR KROSZNER: Well, I think this has

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1 been an extremely helpful discussion on this very
2 important issue, and I think it's been very valuable
3 to have the back and forth of seeing, I think, certain
4 areas of agreement that have emerged with respect to
5 the role of escrows, even though there may be still
6 some differences about guidance versus rules.

7 One of the things we'll be talking about in
8 the afternoon panels is the effectiveness of guidance
9 adopted by the states in general, or whether a rule
10 would be necessary. So I think that's a very
11 important issue that will be coming up again this
12 afternoon.

13 But as I promised, we'll take a break. So
14 we'll have a break right now, but we will start
15 promptly at 10:30. Thanks.

16 (Whereupon, a short recess was taken.)

17 GOVERNOR KROSZNER: We'd like to get started
18 again.

19 (Pause.)

20 GOVERNOR KROSZNER: Once again, I want to
21 thank the panelists for an excellent discussion for
22 the first set of issues, concerning escrows.

23 But now we have three other topics that I
24 had mentioned. One was prepayment penalties; second,
25 stated income as well as no and low documentation

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1 lending; and then appropriate consideration given for
2 borrowers' ability to repay.

3 We've got about an hour and a half left, so
4 I'm hoping to spend about half an hour or so on each
5 of those topics.

6 So let's get to prepayment penalty issues,
7 and in my opening remarks, I talked about how in
8 certain cases they may provide some -- there may be
9 legitimate reasons for use of them. But there also
10 may be abusive uses of them.

11 So I want to turn to my left, to talk a
12 little bit more about that --

13 MR. RHEINGOLD: Appropriately.

14 (Laughter.)

15 GOVERNOR KROSZNER: About those -- good.
16 Those people got met, to see what your thoughts are on
17 whether these things are something that need to be
18 just a broad rule against them, or whether the
19 guidance might be appropriate, or whether, you know,
20 whether there could be some opportunities for them to
21 be used in a way that could be helpful to the certain
22 classes of consumers.

23 MR. CHANIN: So who wants to start?

24 MS. BRAUNSTEIN: Ira, please.

25 MR. RHEINGOLD: You want me to start? Okay,

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1 I started last time. In our view, prepayment
2 penalties in the subprime marketplace are probably the
3 most cynical thing to be done, particularly in the
4 last few years when we've seen the 228s and 327s and
5 the adjustable rate mortgages.

6 Those loans are written for prepayment,
7 period. They are forms. They're created with the
8 full notion that people are going to prepay those
9 loans. Those prepayment penalties exist merely as
10 extra cash capital for the lender, because they know
11 it's going to pay and people don't know that that cost
12 is there.

13 I see no rational reason why prepayment
14 penalties exist in that subprime market, in that
15 mortgage market space. I think they should be
16 excluded, and I don't see any real benefit to the
17 consumer.

18 I have yet to talk to a consumer who said
19 -- it's funny, because I remember when I refinanced my
20 house, because everyone always goes back to their
21 experience in refinancing their houses.

22 I don't remember going and saying "Hey, can
23 I get a prepayment penalty, because I'm not going to
24 prepay this thing, and I'd like a lower interest rate.
25 Could I get a prepayment penalty?" They said "No, we

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1 don't offer that for the kind of product that you're
2 going to get."

3 MR. BREWSTER: So you had a lot of choice,
4 is what you're saying.

5 MR. RHEINGOLD: I think it's false. I think
6 it's not true. I don't think consumers choose
7 prepayment penalties because they're going to get
8 lower interest rates. I think it's incentive-driven
9 in the subprime marketplace. I'll let others talk
10 about, you know, how each structure is eliminated.
11 But I think they're a bad product.

12 MS. BRAUNSTEIN: But Ira, I guess I just
13 want to clarify. Is it only for the hybrids where you
14 see a problem, or is it just in general, or what do
15 you --

16 MR. RHEINGOLD: If you're talking about --
17 it's interesting. It's an interesting question. On
18 fixed rate mortgages, fixed rate subprime mortgages, I
19 wish I saw more of those.

20 We're not seeing a lot of those in the
21 marketplace, and maybe an argument can be made that
22 that's what makes prepayment penalties, makes some
23 sense, the fact that that actually equates to a lower
24 interest rate, then maybe that makes some sense.
25 That's not what we're saying today.

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1 And again, one, that's not the product
2 they're doing, and two, if it actually serves the
3 lower interest rate and really benefits the consumer,
4 then I think that's okay. But I think in the
5 marketplace we're seeing now an adjustable rate
6 mortgage with the full expectation of receiving
7 prepayment penalties.

8 I was looking at a chart yesterday.
9 Seventy-five percent of all the loans that had a reset
10 in 2006 had the prepayment penalty paid out. That
11 doesn't count that 12 percent of those loans that are
12 in default right now.

13 Seventy-five percent of the 2006 prepays
14 that had a reset rate and an adjustable rate mortgage
15 prepayment. Twelve percent of those loans have -- are
16 in foreclosure, and 12 percent are far behind. So
17 everyone knows those loans are going to be -- those
18 prepayment penalties are going to be charged.

19 GOVERNOR KROZNER: Let me turn to my right,
20 and see other perspectives on -- essentially, some of
21 the challenges if we were to do a more broad-brush
22 approach, of just saying these are inappropriate.
23 What are some of the unintended consequences that you
24 see there?

25 MS. SCHWARTZ: Well, it's interesting.

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1 Prepayment penalties are in the segment of the
2 mortgage market, because they used to refinance every
3 three to six months in the mid-90's and the early
4 90's. To bring investors and capital into the market,
5 prepayment penalties were designed to keep people and
6 loans for two, three -- and back then, and I'd agree
7 with others, to say five years was still way too long
8 for someone who may need to refinance the loan before
9 that.

10 The purpose of a prepayment penalty can be
11 to preserve an investor certainty that they'll give
12 -- money for a loan that stays on the books longer
13 than three or six months, which was the practice in
14 the mid-90's, and we all know it. High rates means
15 business, credit life insurance. It's a very
16 different market.

17 Today, one of three loans falls in the Alt-A
18 or subprime loan market. One of three loans last year
19 fell outside of the fixed rate Fannie and Freddie
20 loans. There are a significant amount of prepayment
21 penalties in that non-traditional segment of the
22 mortgage market.

23 So Ira says it's all cynical, because
24 they're on 228 ARMs or 327s. Well, they'd be cynical
25 if they were five year prepay on the 228s, or a three-

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1 year prepay on a 228, where you would cause that
2 borrower to have to pay that penalty upon the reset of
3 the mortgage, if they chose to refinance.

4 But in fact, if responsibly used, prepayment
5 penalties, programs can match the duration of the
6 fixed rate portion of the ARM. If we don't have a
7 choice, like you had a choice; you still didn't get
8 one.

9 MR. RHEINGOLD: They didn't have a choice.

10 MS. SCHWARTZ: They didn't have a choice.
11 They couldn't get one, but at least you weren't
12 mandated on one. They're not the problem. If you
13 don't have a choice and if you're not getting a lower
14 rate, absolutely that's deceptive.

15 MR. RHEINGOLD: That's what were these
16 about.

17 MS. SCHWARTZ: Well, I'm with them. I'm
18 with them. So I guess my point is I put that in
19 regulation, put it in regulation. Put it in perhaps a
20 targeted regulation. That's very serious around
21 HOEPA, Section 129, that includes the substantive
22 requirements about how the use of that prepayment
23 penalty is used.

24 I think if you're not seeing that across the
25 board, you'll see market reform on the problem in that

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1 market.

2 MR. RHEINGOLD: Well, I have one response
3 and I'll let others speak. But I think it's not
4 sufficient to make prepayments for a batch of fixed
5 rate term --

6 MS. SCHWARTZ: Or a 30-day before it sets or
7 something, or 60 or whatever that might be.

8 MR. RHEINGOLD: Or six months or a year.

9 (Laughter.)

10 MR. RHEINGOLD: Because again, I think
11 people fall into the trap that in fact that prepayment
12 is not going to happen, if it happens prior to that.
13 That's when the refinance loan comes into play. I
14 think it has to be significant before that --

15 MS. BRAUNSTEIN: Can you suggest what you
16 think an appropriate time period would be?

17 MR. EAKES: Well, it should be no less than
18 six months. I would make the case for lack of
19 prepayment penalties should be in this subsection, not
20 in every subsection.

21 The first thing is every single rate sheet
22 for subprime lending that I know of would show a half
23 percent decrease in the rate, if you accept or choose
24 a prepayment penalty, okay. So there's no argument on
25 what on the surface the rate tradeoff looks like.

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1 It's roughly, for prepayment it's only a half percent.

2 The challenge is, and this was really, I
3 would think, when we were negotiating the North
4 Carolina predatory lending bill back in 1999, we had
5 all of the bank attorneys, which represented four of
6 the ten largest banks in America were located in North
7 Carolina, what they told us was they said we would be
8 perfectly fine in North Carolina if had a prohibition
9 on prepayment penalties across the board, for all home
10 loans that were below \$50,000.

11 What they said was we have brokers who bring
12 us a loan and want to be paid premium, because they
13 have sold the borrower a higher rate. You don't get
14 paid the premium unless the rate is higher than market
15 rate on the loan.

16 What the lenders then said to us was we have
17 to have a prepayment penalty, not because we have to
18 keep it for a long time, but we know those loans will
19 be refinanced perhaps by the very same broker within
20 one month, and get another premium down the street.

21 So we have to have at least a prepayment
22 penalty equal to the amount of the premium that we
23 paid to the broker. It was the first time that it
24 dawned on me, that really the prepayment penalty is
25 very subtle. It looks like you have on the rate sheet

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1 that you're going to get a seven percent loan or,
2 with prepayment penalty, 6-1/2.

3 But the way it works in practice is someone
4 brings in a loan that would have qualified for that
5 seven and 6-1/2 tradeoff, that is at 8-1/2 or 8,
6 depending on whether they have a prepayment penalty.

7 Without the prepayment penalty, you can't do
8 the racial steering that we see so often in this
9 industry. So I would argue that this segment, and
10 particularly because if you are African-American or
11 Latino, in any marketplace in America for home loans,
12 you are 500 percent more likely to get prepayment
13 penalties in America today, because of the steering
14 between subprime and prime.

15 The prime marketplace where you really do
16 get competition, and people understand it better and
17 there are free riders on the market, have two to four
18 percent of the loans that have prepayment penalties.
19 You can't tell me that the borrowers who have credit
20 blemishes, who have less choice in the market because
21 they're more desperate, choose 70 percent of the time
22 to have that feature.

23 It really is something that is what is
24 offered to the borrowers. It is a mechanism of
25 compensation. What we did in North Carolina is

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1 prohibited prepayment penalties. We restricted it not
2 to restrict overall lending; we allowed the interest
3 rate on subprime loans to float as high as they need
4 it to be.

5 We just said let's take the compensation
6 that was least transparent and move it back into
7 payments and back into penalty fees, and do away with
8 it.

9 One other point and I'll be quiet. I was at
10 a panel discussion with the general counsel for New
11 Century, and he said to me "Why are you so worried
12 about the rate resets, this exploding payment after
13 two years, because whether you're fixed rate or
14 anything else, we refinance these loans. We refinance
15 them all virtually before we ever get to the two-year
16 period.

17 "You shouldn't be worried about the reset,"
18 and I'm thinking well, that's a good argument to me
19 about why the reset is irrelevant.

20 But it's a devastating argument about what
21 prepayment penalties are. If you think about it, a
22 prepayment penalty in every case in this marketplace
23 is paid out of the equity of the home.

24 The borrower hasn't saved up money in order
25 to pay the prepayment penalty. It is a very

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1 sophisticated way of having asset-based lending, that
2 part of the compensation, the back-end fee.

3 I would argue that under HOEPA, one of your
4 standards is if there is a practice that begins to
5 take loans out of the HOEPA category. If you have a
6 premium interest rate, say you're charged an extra one
7 percent, which happens all the time throughout this
8 industry, above what you qualify for, and you put a
9 prepayment penalty on top of that for two years, three
10 years, you have in essence paid up front fees.

11 You're going to pay it, either in the
12 interest in the higher premium rate, or you're going
13 to pay it in the prepayment penalty at the back end.
14 Why does that not count in calculating the fees that
15 would kick you into a HOEPA loan? It is a method of
16 offloading that makes no rational sense.

17 Most people in America outside of economics,
18 you know, I actually studied economics. I know you
19 guys don't believe that. What we're doing here, it is
20 possible clearly to have a prepayment penalty and have
21 it lower the rate. That's what in economic theory it
22 should do.

23 But all of the studies that we've done, the
24 professor at Harvard did, showed that when you
25 actually look at what happens, the borrowers do not

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1 get a net lower rate, because they come in at a higher
2 rate, get deducted a half percent for prepayment
3 penalty, and it's really pernicious chain that in
4 subprime should just simply be prohibited.

5 The most cynical thing you could do as the
6 Fed is to have a rule that says we're going to
7 prohibit prepayment penalties that last beyond the
8 first reset period.

9 That would give the appearance that you had
10 done something. But in essence, you would have done
11 absolutely nothing, because the borrowers are going to
12 be flipped 70 to 80 percent, as Ira said, before they
13 ever get to that reset period.

14 So whether it's fixed rate or adjustable
15 rate, that really is not adequate. For me, since my
16 goal has been to work with minority borrowers, the
17 fact that this market is so disproportionate, it ought
18 to be just really repugnant to us that an African-
19 American borrower, just by the fact that they're
20 African-American, get a prepayment penalty, whether
21 they quote "choose it or not," and it's going to be
22 500 percent more likely if you're African-American or
23 Latino. I find that just appalling.

24 GOVERNOR KROSZNER: Well Martin, I've been
25 an economics professor many years, and it's very clear

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1 that you are very well-schooled in economics. So I
2 never thought that you were not so well-trained in
3 economics. You have quite a sophisticated
4 understanding of those things.

5 MR. EAKES: I've been in the habit.

6 (Laughter.)

7 GOVERNOR KROSZNER: Certainly it is better
8 than we could hope for. Any thoughts and response to
9 that? Yes.

10 MS. DAVIS: I don't want to be cynical, but
11 I do want to be very thoughtful on this issue. I
12 think we're all aligned on this panel in terms of
13 being very supportive of the consumer. At Wells
14 Fargo, I mean we are -- our consumers' financial
15 success is our vision. It's what drives us. Their
16 success breeds more success through a lot of different
17 ways.

18 If they're successful, they're going to do
19 more business with us, which makes us more successful.

20 So we all have this same motivation. We all share
21 the same passion.

22 I just want to be very thoughtful that when
23 we do something that we think is well-intended, that
24 there aren't any unintended consequences that create a
25 problem.

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1 So when I think about this, what are the
2 impacts in the marketplace, what is the reaction to
3 the investor, the loan is prepaid faster than what has
4 been modeled or what the return that they expect as an
5 investor, then you may pull back on that.

6 I do believe, as Faith said earlier, that
7 there's got to be a clear benefit, you know. You've
8 got to be able to show it. They should have choice.
9 I do believe, and we can have dialogue or discussion
10 relative to what is the appropriate period.

11 At Wells Fargo right now, we currently say
12 it's the adjustable period or the fixed period of the
13 adjustable if you prepay in that period, or the lesser
14 of three years. So if you had a five year adjustable
15 period and you prepaid at three, then the prepayment
16 penalty would not apply.

17 So there's going to be rich dialogue in
18 terms of what is that period. But I just think you
19 have to look at it in a broad perspective, and look at
20 what are the potential outcomes.

21 MS. BRAUNSTEIN: Susan, do your prepayment
22 penalties extend right to the reset date, in the sense
23 like for a 228 or a 327? Or does it end a little
24 before that, to give people a chance to get out of
25 that loan without paying it?

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1 MS. DAVIS: It is at the reset period.

2 MS. BRAUNSTEIN: At the reset?

3 MS. DAVIS: Yes. If you do refinance with
4 us, we're going to waive it.

5 MS. BRAUNSTEIN: As long as they refinance
6 with you, as opposed to another lender?

7 MS. DAVIS: Right.

8 MR. CHANIN: Let me follow up on that. I'm
9 not an economist, but I do work for several of them.

10 (Laughter.)

11 GOVERNOR KROSZNER: Whether he likes it or
12 not.

13 MR. CHANIN: Right. But --

14 MR. EAKES: He's a lawyer. That's even
15 worse.

16 MR. CHANIN: But it's hard for me to think
17 that if a loan or the market has prepayment penalties
18 in a fairly significant portion of the market, that
19 that's a, you can call it a revenue stream or whatever
20 you like, in terms of if will bring in some degree of
21 funding for lenders, for those consumers who do
22 prepay; that is, it is implemented for some lenders.

23 It's hard for me to believe that if you
24 eliminate it, if you were to ban prepayment penalties,
25 whether by product or subprime and so forth, that

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1 there would not be some implications for pricing.

2 So the question, kind of following up Susan
3 on your comment, as well as others is, you know, it's
4 hard to predict such things. But I would think there
5 would be some fallout in terms of either higher rates
6 or different terms or something. Can you comment on
7 that, if there were a ban on prepayment penalties?
8 Faith?

9 MS. SCHWARTZ: Well, it's a great question.
10 I'm not sure how accurate or relevant this would be.
11 Three years ago or so, we with some other folks
12 commissioned a study on that, some Wall Street entity,
13 Pentalpha Global Capital in fact circulated that study
14 to several people, some on this panel.

15 Since it's dated, it's hard to know. But
16 the thought was well just eliminate all the prepay
17 penalties. What would it do to the market, with no
18 change in the borrower's credit, no change in the
19 characteristics of the loan other than removing the
20 prepayment penalty?

21 At that time, it was suggested the whole
22 non-prime sector could rise 100 to 120 basis points,
23 with no other change. I suspect, you know, that can
24 be poked at now, because I just don't know how
25 accurate it is today.

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1 But that was -- when the discussion kept
2 going on, we were looking for information on well,
3 could we just eliminate them? What would it really
4 matter? Would investors still stay, and the guilt
5 they would require would be much higher.

6 The economists know better than I do, but as
7 you rise in your rates for your required yield, you
8 also worry about loans prepaying rapidly. It's very
9 asymmetrical, that whole argument. But we do have a
10 dated paper that maybe someone could improve upon and
11 create a new paper, just to see is there a market in
12 fact.

13 Then maybe it would settle down and maybe
14 the market would rationalize to get in a different
15 spot, and maybe that's a good thing too. But I think
16 that's information we should all have on this issue.

17 MR. EAKES: There are a number of states
18 that have prohibited prepayment penalties for
19 subprime. In North Carolina, the General Assembly
20 assumed that getting rid of single premium credit
21 insurance and prepayment penalties would have a higher
22 interest rate of between a half and one percent.

23 As it turned out, it didn't occur. We
24 weren't sure, and what we think that meant was that
25 there was overage pricing. So once you took the

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1 prepayment penalties out, we actually did not get the
2 increase in interest rates in that sector that we
3 expected, which meant that there was some market
4 imperfection.

5 But you would expect, if there's a half a
6 percent reduction in rates, that it might go up as
7 much as a half percent.

8 MR. CHANIN: Were those -- let me ask you.
9 Before kind of the discounted, if you will, subprime
10 loans like 228s and 327s, because obviously if it's an
11 forming index or a fixed rate subprime loan, then the
12 pricing is set there. But for the 228s, it's
13 discounted for the risk of the borrower.

14 So at least some have argued the prepayment
15 penalty compensates for that risk. So did the North
16 Carolina law look at or study, look at those types of
17 products?

18 MR. EAKES: I think the thing is that your
19 point is a really good one. We had this negotiation.

20 I think Faith was part of that four or five years ago
21 with Lehman Brothers.

22 MS. SCHWARTZ: Five years ago.

23 MR. EAKES: How long ago? I thought it was
24 longer?

25 MS. SCHWARTZ: Longer.

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1 MR. EAKES: It was really interesting what
2 came out in this really open discussion, that the
3 investor, people representing the investor markets
4 said we get, despite the rhetoric, 80 percent of the
5 value of the prepayment penalty is not the change in
6 behavior, it's not the slowdown in the prepayment
7 rate.

8 Eighty percent is the cash flow of the
9 penalty, which they know they will receive, because 70
10 to 80 percent of the loans refinance during the prepay
11 period. So they know that.

12 It really is not so much the change. The
13 change in prepayment speed back then, when we were
14 looking at it, was the difference between 20 percent
15 CPR and 17 percent, which is a difference. But it
16 wasn't a really, truly dramatic difference in speed.

17 That meant 20 percent would prepay each year
18 if they didn't have a prepayment penalty, and only 17
19 percent would prepay each year if they did.

20 So I think that if the market is efficient
21 now, if you take one of the measures of cash flow
22 away, which prepayment penalties collected routinely
23 will be, there has to be some increase in rate, or
24 else the market is not efficiently pricing them.

25 MS. SCHWARTZ: You know, I think the

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1 question here is about transparency of pricing. How
2 many people here have a prepayment penalty on their
3 loans?

4 MR. EAKES: How many people know?

5 (Laughter; simultaneous discussion.)

6 MS. COHEN: Great. So we've got one. So in
7 the subprime market, it's 70 percent. This is exactly
8 like credit card pricing. If you want to know what I
9 think about your credit card proposal, we can talk
10 about that later.

11 (Laughter.)

12 MS. BRAUNSTEIN: A different forum.

13 MS. COHEN: In the credit card market, some
14 people know what they're going to pay, because they
15 don't really pay late. Then a bunch of people pay all
16 these fees at the back end.

17 Similarly, what we're seeing in the subprime
18 market is some portion of what people are paying they
19 don't know about up front, because they don't really
20 either (a) know about the prepayment penalty, (b)
21 understand the prepayment penalty, or (c) appreciate
22 how likely it is that they're going to be flipped,
23 because generally it's not their idea to do so.

24 So to the extent that you're seeing most of
25 it being about cash flow, don't people have the right

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1 to know what their loan's going to cost, and don't
2 they have the right to have their loan underwritten
3 for that in some appropriate way?

4 GOVERNOR KROSZNER: Well, this raises the
5 important point of disclosure, and obviously, as I've
6 mentioned in my introductory remarks and as you well
7 know, we're reviewing our disclosure proposals.

8 Is this something -- could we at least
9 partially address it, perhaps not completely address
10 it, but at least partially address it through improved
11 disclosure?

12 MS. COHEN: My view is any abuse needs to be
13 addressed by a substantive regulation. If you want to
14 supplement it by disclosure, we have plenty of ideas
15 about how disclosures could be improved. Most of them
16 don't ever end up getting adopted. But we're happy to
17 provide them again.

18 (Laughter.)

19 MS. COHEN: The bottom line here is what
20 people receive, not whether they understand it not.

21 GOVERNOR KROSZNER: Well, no. I do think
22 it's very important that they understand what they're
23 going to pay. So that they're not independent of each
24 other. It is important what they ultimately do pay.

25 But one of the hopes is that we can at least

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1 improve for more people, certainly not for everyone,
2 their ability to understand the type of contracts that
3 they're getting into.

4 MR. SANCHEZ: We'd probably agree that that
5 is right. A lot of the problems that we care about in
6 the marketplace are people saying oh, my God. I
7 didn't understand that I had this right.

8 So I think the issue of disclosure, and
9 having it up front. For example, we make it a part of
10 our up front RESPA package, and it is out there in
11 front for the customer to be able to see and
12 understand it.

13 As we drive that more to their decision
14 point, and have a standard by which we all who have to
15 play, I think it's very, very important. The idea
16 that the theory of a prepayment penalty should have a
17 lower cost of entry for the consumer, I think, is
18 right if we make it real.

19 We haven't done a good job of that in the
20 industry, because we've extended these prepayment
21 penalties beyond resets, where we know people are
22 going to change.

23 I think we have to adopt something that says
24 we are not going to go past that first adjustment
25 period, and secondly, to the point of the folks before

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1 me, we have to give the consumer a reasonable period
2 of time before that adjustment sets, so that they
3 don't have a prepayment penalty and they aren't forced
4 to either come back to us, right, and have the ability
5 to be in the open market and have the ability to be a
6 consumer, right.

7 So I think the prepayment penalty exists for
8 a reason. I think we all have an expectation that it
9 should be of mutual benefit, right, both to the
10 consumer and to us, so that we can generate a
11 reasonable profit and provide liquidity in the market
12 and opportunity for folks.

13 MS. BOWDLER: And you're -- just thinking --
14 oh, sorry. Do you want me to --

15 GOVERNOR KROZNER: No, Alys can respond.

16 MS. BOWDLER: Go ahead.

17 MS. COHEN: I agree that disclosure and
18 choice are good where they're available. In the late
19 90's, when the first predatory lending hearing was
20 held on the Senate Special Committee on Aging, John
21 Breaux, Senator from Louisiana, announced that he
22 didn't read the closing papers on his mortgage.

23 Now maybe he had the privilege of not
24 needing to understand or read the closing papers on
25 his mortgage. But the people who we see, whether or

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1 not they'd like to understand their mortgage, a
2 disclosure is not going to solve their problem.

3 So we're all in favor of better disclosure,
4 but the question is whether that's the full answer to
5 the problem. I took a cab here this morning from
6 Union Station. My cab driver is a civil engineer from
7 Ethiopia. He's been here for ten years and is a
8 citizen. He's got a bunch of kids, he owns his home.

9
10 I said "Oh, I'm going to the Fed. I'm
11 involved in a meeting. We've got these rules." He
12 said "Oh, is it about mortgages?" I said "Yes, it's
13 about mortgages."

14 He said well, the real problem is, and this
15 is the point I'd like to make, he said "People see an
16 advertisement like in a newspaper, and they come and
17 they find out that rules are different. But by the
18 time they figure out that the rules are different, and
19 that's the part, because disclosures up front are not
20 enforceable, by the time they find that out, they
21 don't feel like they can leave. They feel desperate,
22 and they sign the papers anyway.

23 Now if he understands that, why can't we all
24 implement a rule that appreciates some of this, or you
25 guys implement the rule.

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1 GOVERNOR KROSZNER: Janis.

2 MS. BOWDLER: Well, Alys stole a little bit
3 of my thunder.

4 MR. CHANIN: You were in the same taxi?

5 (Laughter.)

6 GOVERNOR KROSZNER: Well done.

7 MS. BOWDLER: What I was going to say is,
8 you know, in the hearing that we had last summer, the
9 panel I was on was looking at consumer choice, and how
10 do consumers make decisions about the products that
11 they get.

12 We know that consumers don't have the tools
13 that they need to shop effectively, and we know that
14 they go to mortgage brokers because they assume that
15 the broker shops for them.

16 So when we talk about whether or not
17 consumers are actually making the choice to get that
18 prepayment penalty, it's very unlikely. They come in,
19 as we've already talked about. They get quoted a
20 monthly payment, and that's where all decisions are
21 really made.

22 So just to answer your question,
23 specifically about looking at the idea of what would a
24 disclosure look like for the prepayment penalty, I
25 think we also need to think about it in the context of

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1 what exactly is it, and how exactly are you disclosing
2 it?

3 Because are we disclosing it as a fee, which
4 is how it's operated functionally acting in the
5 market, or as a potential tool to discount the cost of
6 your mortgage. To me, you can only disclose it as a
7 potential discount to your mortgage if it's actually
8 doing that, and we've heard already all of the
9 problems of why we think that that's not happening in
10 the marketplace.

11 So in thinking what a disclosure would look
12 like, we'd have to think about is it a fee, or is it a
13 discount, and how we talk about that? Then of course,
14 can we get it to them in time, where they can actually
15 act on the information that they're receiving.

16 MR. CHANIN: Martin, I think to follow up on
17 one comment that I think you made, and that is I
18 believe you said that, for example, providing a time
19 frame before the reset date would not be a
20 satisfactory answer to this.

21 That is, allowing the consumer to prepay
22 without a penalty for some time framer before that.
23 If you said that, why is that the case?

24 MR. EAKES: Let me hedge my bets a little
25 bit. If you're going to have a limit but not prohibit

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1 prepayment penalties, it needs to be at least six
2 months before the reset period. Because the mortgage
3 processing takes time, particularly if you have credit
4 blemishes you have to fix.

5 If you say within 30 days, it's just a joke,
6 because you then get to the closing table. You are
7 forced to close even if you have a disastrous loan put
8 in front of you. So when I was saying that it's
9 particularly cynical to say that we would have a
10 regulation that said the prepayment penalty can't go
11 longer than the reset period, I just believe that has
12 no impact.

13 What I believe is that the prepayment
14 penalty, we have a market where we see what consumer
15 choice is in the prime market, and roughly four
16 percent choose prepayment penalties. We shouldn't
17 judge our policy on what I call the fertile
18 octogenarian; you know, the one case where it might
19 happen. It might be true, and then let that drive our
20 policy.

21 Well, that's what we're doing when we talk
22 about prepayment penalties. There may be a couple of
23 people who really would get a benefit. But for most
24 people, the asymmetry of information is dramatic.
25 Nothing else I say is going to be heard, right? You

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1 have the image of the --

2 GOVERNOR KROSZNER: We're trying to keep
3 that out of our head. But go ahead.

4 (Laughter.)

5 MR. CHANIN: I guess part of it though, is
6 the pricing appropriate? That is, is the market
7 functioning properly? That's one issue.

8 The second issue though, and to the extent
9 you can divorce them, is if there's a problem with the
10 way the market is functioning in terms of prepayment
11 penalties, and thus consumers, in a sense, have to pay
12 the penalty or have to roll it over with the lender or
13 have to pay the reset rate, can you address that by
14 having a window of time, whatever is appropriate,
15 before the reset date, permitting the consumer to
16 refinance without that?

17 MR. EAKES: You see, what I'm telling you is
18 this problem is -- this one is not tagged to reset
19 only. If you had every subprime loan in America with
20 a fixed rate, there were no reset whatsoever; we had
21 even done escrows and they weren't triggers for
22 refinancing, these are very short term loans, where
23 the borrower assumes they're going to be able to be in
24 the loan for longer than they do.

25 That's why I say it's asymmetric

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1 information. No one would choose a prepayment penalty
2 unless they thought they would be in the loan to
3 recover, and in many cases it's going to leave a half
4 year of interest times 80 percent.

5 Well, that's true, because the higher your
6 interest rate is, the worse your loan, the more locked
7 into it you are at that point. So that's the standard
8 prepayment penalty today, is the higher your interest
9 rate, the more you need to be able to refinance, the
10 more pernicious it is for you to try to do that.

11 MR. RHEINGOLD: Let me take a crack at this
12 as well, because I'm thinking about the role of abuse
13 prior to the adjustable rate mortgages, and why they
14 were bad even then.

15 But the fact is is that I don't believe that
16 prepayment penalties exist because there's an
17 assumption of the subprime market that consumers are
18 rationally going to choose to get out of that for that
19 matter, and go ahead and get a new loan.

20 In fact, I sort of view it as mortgage
21 lenders protecting themselves from each other, because
22 they know there's this voracious appetite to flip
23 people and continue to refinance them and equity
24 strip. The prepayment penalty existed because they
25 knew it was going to happen, because as soon as the

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1 loan closed, three months later, six months later,
2 they were going to be approached by a new lender to
3 say "We can do this for you and we can do this for
4 you."

5 That prepayment penalty wasn't because a
6 consumer was rationally going to -- because there was
7 a concern that a consumer was rationally going to get
8 out of that loan. It was because they knew the rest
9 of the industry was going to devour that consumer. So
10 that's why prepayment penalties. Even if you create
11 that short a reset date, it's not going to solve the
12 entire problem.

13 GOVERNOR KROSZNER: Any response on that?
14 Yes.

15 MR. DINHAM: Not on that particular issue,
16 but I did want to respond to something that Alys said.

17 One of the biggest problems that I've seen in the
18 marketplace for years has been the good faith
19 estimate, and the HUD-1 are not required to be
20 anywhere close to the same.

21 We need to do something to put variances on
22 the good faith estimates, so the consumer will know at
23 that time. In other words, if it increases any more,
24 that they are required to disclose it at some time
25 prior to the actual closing.

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1 It's been a hole in our system for as long
2 as I've been doing this. I started before they had
3 Truth in Lending and RESPA too. So I've seen it all
4 come about, and one of the most confusing things is
5 about one of your forms too, is that you continue to
6 put the APR but not the number right on there. The
7 consumer really gets upset about that.

8 But I would really like to see us do
9 something that gives the consumer more assurance at
10 the time of application, that these are actually
11 figures that you're going to see, or he's going to be
12 resolicited. So I think that that's another issue as
13 the slope is concerned.

14 GOVERNOR KROSZNER: Any last words? I'm
15 coming to -- we've spent like a half an hour on this,
16 so I want to bring this section to a close. Anything
17 more on this issue?

18 MS. COHEN: Can I just say one quick thing
19 in response to what Harry said? I think it was said
20 before, and I just want to point out that most of the
21 clients are not required to do so in any way that
22 would have a penalty associated with it.

23 So I think those two things would go hand in
24 hand. That may not be about the people here, but just
25 to get it on the record.

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1 GOVERNOR KROSZNER: Any further thoughts?

2 Yes.

3 MS. DAVIS: I have thought about what's the
4 right approach, and I am concerned that I believe in
5 choice for customers. I believe in information so
6 that they can make good decisions. Again, their
7 success correlates back to our success.

8 Markets are very, very efficient. I worry
9 about trying to take actions or create a change
10 without understanding all of those dynamics, or doing
11 so because you're trying to solve the bad actors or
12 the unregulated. I just have a concern there.

13 MR. EAKES: The last point I wanted to make
14 on it is to say that you should think of a prepayment
15 penalty loan similar to a neg am loan, that you are
16 going to be paying three or four percent of the
17 payments for the period you hold the loan out of the
18 equity in the home, just as if you said at the
19 beginning of the loan, to make it more affordable,
20 we're going to lower your payment and add to the
21 balance of your loan.

22 So that any protections that are
23 appropriate, and I'm not saying that neg am loans are
24 inappropriate and offsetting, but I think in subprime,
25 with borrowers who are vulnerable, there are cautions

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1 that would lead me to say it's okay to do away with
2 prepayment penalties, as eight or ten or more states
3 have done across the country.

4 MS. DAVIS: Again, I just want to be very
5 cautious. We've already said we do not do negative am
6 loans.

7 MR. EAKES: But you do prepayment penalties
8 --

9 MS. DAVIS: And we do. We do offer
10 consumers prepayment penalties with what I believe is
11 good information, choice and abatement. And again, we
12 have limits on the period for the prepayment penalty.

13 So I don't correlate those two together in the way
14 that you have.

15 GOVERNOR KROSZNER: This has been a
16 fascinating discussion of these issues. I'm thinking
17 about exactly are there benefits or are the benefits
18 so strong that the cost of eliminating the practice
19 outweigh any potential unintended consequences.

20 But I think we've had a good discussion back
21 and forth there. Also, I think a good discussion of
22 the role of disclosure, whether it can or cannot be
23 effective in this particular area. So I'm very
24 pleased that we had that.

25 But now, if it's okay, I'd like to move on

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1 to the next topic, which is something I'm sure will
2 generate no controversy at all, stated income or low
3 and no documentation loans. My hunch is people will
4 have some different perspectives on this, and this
5 obviously is another thing that's of great interest to
6 us here at the Fed.

7 So thinking about guidance, any kind of
8 rules. Who would like to start talking about that
9 issue?

10 MR. CHANIN: Oh, we're on the next topic?

11 (Laughter.)

12 GOVERNOR KROZNER: I think we'll start it
13 to the left. So why don't we do that? Remember, the
14 Fed is right in the middle.

15 (Laughter.)

16 MS. BRAUNSTEIN: No, I would like to -- I
17 could start this by just posing a question actually to
18 the right, to the industry, which is, you know, one of
19 the things we hear often is that we should ban stated
20 income loans, and that there's no good reason in 2007,
21 with technology and information available at people's
22 fingertips, that somebody can't produce something that
23 shows what their income is for a loan.

24 So I'd like to know from your perspective
25 what the implications are of no stated income loans,

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1 and where these actually are done responsibly, and
2 where they are necessary and helpful to people.

3 MR. SANCHEZ: Okay, I'll start. I think it
4 would impact all of us, to do away with them. While
5 this is a very complex part, even more complex is the
6 number of ways people earn income, and are able to
7 disclose income.

8 So I think we start with the panel on the
9 left and we're talking about the Latino community, and
10 the different ways in which they earn income, in cash
11 and those type of things.

12 I think what we've got to do as a
13 responsible lender is to make sure that there's some
14 reasonableness to what folks are stating, and that we
15 have tried to get to a level of documentation that is
16 right. It's very easy to do that when we've got a
17 wage earner in a very traditional job, to get the
18 paycheck that we need for documentation.

19 So that's easy for us to do. When that same
20 person also has a job on the side to support them
21 along with other family income, it's very difficult to
22 do. So I think it's prudent for us to establish a
23 reasonableness standard for stated income, right?

24 We shouldn't see a dishwasher come in with
25 an application that says they make \$200,000 a year.

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1 That's not reasonable. Those are some of the things
2 that we've seen happen in the industry, and that is
3 wrong, and we have got to correct that.

4 So I think applying a reasonableness
5 standard, but understanding there are lots of
6 challenges out there, even in the world of technology
7 today, of people being able to truly document their
8 income, that they've shown us that they've got the
9 ability and willingness to pay. I think that's where
10 we should be.

11 MS. BRAUNSTEIN: Pablo, just following up on
12 that, is there -- do you have any ideas on more
13 specificity, actually, of what you mean by a
14 reasonableness standard? How would you define that?
15 I mean that's kind of a broad term.

16 MR. SANCHEZ: It is, and it's used in a law
17 every single day, that kind of reasonable person test.

18 That's why we have underwriters, and that's why we
19 train the folks to look at these situations. We do
20 use technology and we go to the Internet, and there
21 are sites out there that say this is an average range
22 of what this person is likely to make. We use some of
23 those tools today to figure that out.

24 But it is subjective, and we very much rely
25 on somebody's credit and their history. The best

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1 predictor if someone's going to pay is if they've paid
2 before, right. We have to take all of that into
3 account.

4 MS. BRAUNSTEIN: Anybody else down there
5 want to comment?

6 MS. DAVIS: I'll add a few comments here. I
7 believe that, you know, if you're going to restrict or
8 make any restriction on the stated or low income
9 loans, and I think I said this in my opening, was it
10 has to be tied to a bright line test that can be
11 consistently documented everywhere.

12 I mean we have done that at Wells Fargo.
13 Anything below a 620 FICO is not a stated income loan.

14 I believe there is. I believe stated income loans
15 have merit. I personally have a stated income loan.
16 I do make money, and I do make my mortgage payments,
17 right?

18 So I do it, did it, but for ease and
19 convenience, it creates efficiency. Whoever
20 underwrote my loan, I'm sure understood what my job
21 is, that hopefully that there's a reasonableness test
22 to that income. So I think --

23 MS. BRAUNSTEIN: But can I add, not to get
24 personal, but since you brought it up, is yours a
25 subprime loan?

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1 MS. DAVIS: No, it's not.

2 MS. BRAUNSTEIN: Okay.

3 MS. DAVIS: No, this one is not. Not right
4 now.

5 (Laughter.)

6 MS. BRAUNSTEIN: Not yet anyway.

7 MS. DAVIS: Which is why for us we put in
8 that bright line test at FICOs less than 620.

9 MR. CHANIN: Let me follow up on that. One
10 of the things people have asserted, and it's been
11 pretty kind of strident statement, is that certainly
12 there may be individuals who, because of the way
13 they're paid, may not literally receive a paycheck.
14 So they may not be able to verify it that way.

15 But the assertion, at least that I've heard,
16 is that "But people file their taxes," and let's
17 assume it's someone who has been employed, if you
18 will, at the same occupation or type of job for two or
19 three years.

20 So the assertion is why not, if you don't
21 have a statement from an employer or employers, why
22 not simply require or use a tax form? So I mean we
23 need a response to that or arguments, you know, why
24 that is inappropriate. There may be privacy issues,
25 but people think we ought to use the tax form.

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1 MS. SCHWARTZ: Well, a couple of things. I
2 mean tax forms are used all the time, in both signed
3 and unsigned loans. It may be that ancillary income
4 that Pablo has talked about or other forms of income
5 or, you know, just cash that's not been reported.
6 It's certainly part of that.

7 I'd like to step back and just say, you
8 know, stated income loans have been a conundrum across
9 the market for years. People have always been a
10 little bit uneasy about them in prime, in Alt-As, and
11 subprime.

12 Yet they seem to be pervasive and in the
13 last maybe four years, much more so across the market,
14 and that's true. So what's interesting about that is
15 they perform quite well. They do perform. There's
16 performance. There are other issues in ways people
17 underwrite.

18 Someone may have a lot of reserves. Someone
19 might have a very good FICO score and I would argue,
20 having all FICOs, it's an interesting idea. But there
21 are certainly high FICOs in subprime and not because
22 they were downstreamed in the market, because the
23 product they got was not available in the prime
24 market. That's a big part of the subprime market.
25 It's a big part of the Alt-A market.

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1 Likewise, a lot of great loans that are
2 subprime "cutoff" loans are made in the prime market.

3 Fannie and Freddie do a wonderful job of reaching
4 down where they can, and measuring and layering risk.

5 So I think this is carefully-worded, through
6 the Fed. I think you've got to look at risk
7 layering. Excessive risk layering is a problem. So
8 there are ways to get at it, and just say if you don't
9 have excessive risk layering, and I guess I heard say
10 someone did it by, you know, a FICO cutoff.

11 That is a good cutoff. I'm just suggesting
12 that a risk-basis, versus the market segmentation. I
13 always work when they segment markets for one thing.
14 Then I think if you've had a current pay history on a
15 loan, a loan that's in your servicing portfolio, maybe
16 they don't want to document everything, to refinance
17 to a better loan.

18 I'm not sure a good pay history and a
19 mortgage wouldn't be something that someone could just
20 say just don't even require the income and, you know,
21 make another loan. I mean there are instances where
22 it certainly can be given. Again, in our firm, that
23 reasonableness test, some of the other things are
24 performance tests, and it's really quite similar to
25 that of the full doc loans.

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1 So that's what's made it difficult to just
2 say well, just get rid of them in the market, because
3 the performance over many years for that alone has
4 really been better than expected, I think.

5 MS. BRAUNSTEIN: I hear what you're saying
6 about performance, but would a ban on stated income,
7 are there people, certain profiles of people that just
8 wouldn't be able to get mortgage loans?

9 MS. SCHWARTZ: Oh, I have to think so, I
10 mean just because it's so prevalent in the broad
11 mortgage market. I don't know the answer of how you
12 would measure it.

13 (Simultaneous discussion.)

14 MS. BRAUNSTEIN: Yes. But I just wonder is
15 the prevalence because it's there, it's available,
16 it's easy, or is it because somebody really just
17 couldn't, if they were asked to produce the
18 documentation necessary to get a loan? And that may
19 be a rhetorical question.

20 MS. SCHWARTZ: Yes. I don't know the answer
21 to that.

22 GOVERNOR KROZNER: Janis had mentioned this
23 in her opening remarks, and I want to get back to
24 this issue, because she said there were many people in
25 the Latin American community in the U.S. who may not

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1 have an easy way to document the income that or their
2 family are making.

3 MS. BOWDLER: We start with the NCLR home
4 ownership network, which you guys haven't kind of
5 talked about again. You might be sort of the last
6 people on the earth not to have heard about it.

7 But last year we closed almost 3,000
8 mortgages through our network, 45 community-based
9 organizations working in 21 states. They are working
10 with the population that is going to have the hardest
11 time documenting their income.

12 Ninety percent of our families are below 80
13 percent of the area median income, and a significant
14 portion are even below 50 percent of area median
15 income, and they all get prime or FHA products. Some
16 are portfolio products, some are social programs that
17 they've negotiated on the ground. But they're getting
18 prime products.

19 So we really feel like when it comes to
20 serving the low income, the immigrant community that's
21 going to have the toughest time in this area, we know
22 how to document those loans, how to underwrite them,
23 how to get them into homes responsibly.

24 That said, we know that in a lot of areas in
25 the Filipino community, there are challenges

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1 documenting true traditional means. That doesn't mean
2 they can't document it by any means, but if we're just
3 talking pay stubs and W-2s, there may be some
4 challenges.

5 So my recommendation was get the most
6 appropriate documentation available. Certainly, you
7 know, there's probably a hierarchy there. I think
8 it's hard to say that the market hasn't overreached
9 here. I mean, Martin, how many -- what percent did
10 you say?

11 MR. EAKES: Bear Stearns says that 60
12 percent of loans, subprime loans made in 2006 were
13 stated income, and other analysts have said as much as
14 45 to 50 percent.

15 MS. BOWDLER: Okay. It's hard to believe
16 that that percentage of the market doesn't have W-2s
17 or --

18 MR. RHEINGOLD: Or proof of social security.

19 MS. BOWDLER: Yes, you know, all of these
20 different things that you would need to document the
21 loans. I think there's no question that the market
22 has overreached here, and then, excuse me. The other
23 thing is that we know that there's also product out
24 there that accommodate for the moonlighters, as you
25 like to call them.

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1 There are plenty of prime products out there
2 that allow for a certain percentage of your income to
3 be cash income, up to a certain dollar amount.

4 So I've often seen like 20 percent could be
5 cash income up to \$1,200 a month or something like
6 that, you know. There's plenty of products out there
7 that allow you to account for all the numbers.

8 So if you babysit on the side, you do
9 construction on the side, you can account for that
10 income. So what I hear the industry saying and what I
11 hear a lot from folks working on the ground is that
12 stated income is just a lot easier to put through the
13 system.

14 But it's also more expensive for the
15 consumer. So we've seen this as a real pressure
16 point, where our families have gotten taken advantage
17 of when they can document their income, have no idea
18 what the difference is between a documented loan and a
19 stated income loan, and now they're upsold for a more
20 expensive loan because it's easier to produce.

21 So from our perspective, what we want to
22 avoid is just because you have multiple wage earners
23 and some cash income doesn't mean that you can't
24 document your income, and you're just automatically
25 thrown into these loans because they're easier and

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1 more profitable.

2 I think it's really a sign of the failure of
3 mortgage lenders to be able to legitimately serve the
4 low and moderate income community.

5 GOVERNOR KROSZNER: What sort of
6 documentation would be used in the non-traditional
7 documentation for people who don't have the pay stubs
8 or W-2 forms?

9 MS. BOWDLER: Sure. We've seen, in some
10 cases, letters from employers saying that they receive
11 cash income. You can use bank statements. You can
12 use regular check cashing receipts. You can use a
13 check cashing, which we know they use. Certainly our
14 community uses them.

15 So it can be groups that you regularly cash
16 a certain amount of -- maybe you cash the check, but
17 you don't use a bank or you may not have a full record
18 of that. There can be other ways as well. But what
19 we encourage through the network is that families open
20 accounts, and that they routinely deposit their cash.

21 So that's how we do it, and that's how we
22 try to encourage it. Certainly, our population is one
23 that may carry a lot of cash, and that can be
24 dangerous. So underbanks and other bank populations
25 as a whole is informed, but that's something that we

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1 encourage.

2 GOVERNOR KROSZNER: But of course, that is
3 one of the challenges of being able to try to provide
4 credit products to people who, for one reason or
5 other, they don't feel comfortable with them being
6 part of the banking system.

7 I think for people who are part of the
8 banking system, it's much easier to do the kind of
9 documentation that they've been talking about. But I
10 -- you know, that's why I wanted to explore how can
11 we make sure not to cut off credit to people who've
12 been responsibly borrowing in this area, but they may
13 have, you know, particular challenges in being able to
14 provide appropriate information.

15 MS. BOWDLER: I certainly agree with you,
16 and I think in rural communities, in the colonials, in
17 areas where the banking system is not as developed and
18 not as usually acceptable, it's certainly an issue as
19 well.

20 But people's incomes come from somewhere,
21 and I think that we can be creative and really think
22 through how we can measure that. Perhaps we need more
23 dialogue there, and that I would certainly be happy to
24 participate in that and give you more of my comments.

25 But I do think that it is a very sensitive,

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1 and as I said in my comments, sensitive issue for our
2 community, and it's a careful balance, but one that we
3 are willing to come to the table and talk about.

4 MS. BRAUNSTEIN: I have a question. Again,
5 the fly in the ointment question is if you're told up
6 front you're getting a stated income loan and you
7 don't have the documentation, how is that unfair and
8 deceptive? Anybody who wants to answer that.

9 MS. BOWDLER: Well, I think what probably
10 happens. I mean I have the ads here. It says right
11 in there, don't have to document your income, don't
12 have to document your credit history.

13 I think what's deceptive about it is that
14 they don't know they potentially have another option
15 available for them. But certainly, you know, the fact
16 that they don't have another option available to them
17 is one thing.

18 (Simultaneous discussion.)

19 MS. BRAUNSTEIN: Either unfair or deceptive.
20 How would that meet that standard?

21 MR. RHEINGOLD: I'll pick up a little bit of
22 what Janis is saying, is in fact what we're talking
23 about, is that people, this isn't a question of
24 choice. I don't think consumers have actually -- I
25 mean the numbers are -- I mean it's a rhetorical

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1 question and at some point I'd love to have the
2 answer, is what is the rational explanation that 50
3 and 60 percent of subprime homeowners in the last two
4 years have decided that stated income was better for
5 them.

6 So I think if you sort of base this
7 assumption that's what's happened is that consumers
8 suddenly have this great choice, you can have a stated
9 income loan or you can have an income. You don't have
10 to document by documentation.

11 They're all choosing stated income loans.
12 Well, that's not what's happening. The fact is that
13 if people are given rational choice and said "Hey, you
14 give us your W-2, or you don't give us your W-2 and
15 the cost of your loan is going to be more expensive if
16 you don't give us that documentation."

17 They're going to choose. "Oh no, well I'm
18 not going to bother handing you my biweekly W-2 form,
19 because I want to pay more for my mortgage." I mean
20 that's not what's happening in the marketplace.

21 MS. BOWDLER: And that -- I'm sorry.

22 MR. RHEINGOLD: No, go ahead.

23 (Simultaneous discussion.)

24 MS. BOWDLER: What I was going to say is
25 that I think what is actually put to families is look,

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1 you want that house? You've already seen my friend,
2 the realtor. It's going for sale, and if we don't get
3 you in there quick --

4 MS. BRAUNSTEIN: It's going to be gone.

5 MS. BOWDLER: Yes. So I can get you a loan
6 in a couple of weeks, or you can wait, you know, 45
7 days. That is not the real choice that we would want
8 families to have available for them to be making.

9 Again, I would go back to, in an age of
10 information technology and the ability to improve our
11 automated underwriting systems, we should be able to
12 serve low and moderate income and immigrant
13 communities with the same efficiency that we serve
14 other communities.

15 So I would put -- we have been putting a lot
16 of pressure on our friends at the other end of the
17 table, to speed out those processes, so that families
18 do have a real choice, because I think that's the
19 question that's being posed to them, one of ease and
20 efficiency and quickness, not one of documentation.

21 GOVERNOR KROSZNER: Although I would -- go
22 ahead.

23 MS. SCHWARTZ: Too much time down at that
24 end. No, not really. I think the points have been
25 great, and I think, and I would just like to say, and

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1 the market has been overexuberant, and we all know it,
2 the last couple of years, the last couple of years.

3 But what I would suggest is it's not
4 perfect. But when you are buying loans or working
5 with brokers, when you're not there, you aren't at the
6 point of sale, and back to the choice, because this is
7 an important aspect.

8 We were also concerned about the same issue.
9 We're worried about fraud in the stated income loan.
10 That's classic. The borrower didn't even know she or
11 he had a stated income loan. That was more worrisome
12 than any other issue on stated income, at least for me
13 and for Option One.

14 So what we did is say well, what can we do
15 to make sure that's not the case? I'm going to read
16 you -- indulge me for just a minute -- just a few
17 bullet points on the disclosure we send the day we get
18 the loan application.

19 "You provided the" -- Okay. "Borrower
20 Acknowledgments. You provided the reported monthly
21 gross income in Section V, Monthly Income and Combined
22 Monthly Housing Expense of the Uniform Residential
23 Loan Application.

24 "You have carefully reviewed the Uniform
25 Residential Loan Application to confirm that it

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1 accurately states your income, your assets and your
2 obligations.

3 "You understand that you have the option to
4 apply for a loan using full income documentation,
5 which will result in a lower interest rate. You
6 understand that your qualification for a loan is based
7 in part on stated income documentation.

8 "You understand a stated income," in bold,
9 "is not designed to allow for declaring inflated
10 monthly gross income, for the purpose of qualifying
11 for a loan." And finally, "if you stated an income
12 higher than you actually receive, you may encounter
13 difficulty making your mortgage payments." I think it
14 can go farther.

15 MR. EAKES: Okay. So that's as good a
16 disclosure as you can make. How many of your loans
17 are --

18 (Simultaneous discussion.)

19 MS. SCHWARTZ: It's at 60 percent, in the
20 40's, in the low 40's. But it's high. It's a
21 function of the market. I don't disagree. It's a
22 good discussion. We do the other income limited doc
23 type of things that were announced today.

24 So I think this is healthy discussion. But
25 I'm just suggesting that there is more to this.

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1 MR. EAKES: Let me a give a strawman defense
2 of stated income. You know that something's coming
3 after that, but if you don't have to document a
4 person's income, the closing process can be more
5 efficient.

6 It's less cost, because you just simply take
7 a statement. So long as that worked, meaning that it
8 didn't create catastrophic losses for either the
9 homeowners or the investors, which basically means
10 there's an assumption that income is no longer
11 correlated with loan performance.

12 I mean and during the period of time where
13 housing prices were rising at 15 percent a year, 20
14 percent a year in many markets, that was a valid
15 assumption. Income was not the determinant of whether
16 investors suffered losses or whether borrowers were
17 going to be foreclosed immediately. There was always
18 another flipping refinance two years down the road.

19 In many ways, this issue has taken care of
20 itself in the investor community. The investor
21 community, now that house prices have dropped two and
22 a half percent last year, are predicted to drop as
23 much as three percent this year, the investors are
24 going to be less tolerant of stated income, because it
25 no longer works. That assumption is gone.

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1 This is simply old style banking. I mean
2 even for us radical --

3 (Simultaneous discussion.)

4 MS. SCHWARTZ: No. You're right, Martin.

5 MR. EAKES: --to document income.

6 MS. SCHWARTZ: Martin, you're right. The
7 market has reacted that now you're in the 30's. You
8 have probably stated income maybe more appropriately
9 than it's been priced. But I'm just saying that --
10 and whether it's low documentation or stated income,
11 that's just historically been the fact of why that's
12 been in existence.

13 It's not just the only risk issue. Again,
14 loan to value, FICO, all those other things, people
15 don't make them over 90 percent LTV or whatever that
16 might be.

17 MR. EAKES: Because the estimate is that no
18 more than one to two percent of borrowers do not have
19 W-2s. So that when a very high percentage of
20 borrowers --

21 (Simultaneous discussion.)

22 MR. CHANIN: Let me follow up on that,
23 because I have had a couple of discussions off the
24 record with some lenders, and it's gone like this,
25 that most people have W-2s; most people have pay stubs

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1 or some form.

2 But there are discussions where the consumer
3 doesn't want to provide the W-2 because they have
4 other additional, as Faith alluded to, other
5 additional income to declare, and it puts the lender
6 in an awkward position of putting down something that
7 they know is incorrect, when they've seen the W-2.

8 So I have heard, at least anecdotally, is
9 some part of this market. It goes to kind of Janis'
10 questions or comments. So if you ban stated income
11 loans, what are you doing for that practice or for
12 reliance on other family members who are not on the
13 note in terms of being obligated on the transaction.

14 MR. EAKES: So what I would say to that is
15 if we're going to base our policy on trying to serve
16 tax cheats, that's a challenge. The part that I would
17 respond is we do a lot of loans with Latino families,
18 and virtually every single borrower declares their
19 income and pay tax returns.

20 So I don't want to have an association
21 between low income or Hispanic or African-American
22 borrowers and failure to declare income on tax
23 returns.

24 I just think if we're talking about personal
25 responsibility in the marketplace, that shouldn't be

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1 our first concern, tax cheats. It shouldn't be the
2 basis for maintaining stated income.

3 MR. CHANIN: No, no. It's not a matter of
4 that being the basis. That's the, if you will, the
5 dilemma when the borrower comes to that financial
6 institution, and the institution says no, we can't do
7 this. Then what I've heard is then the borrower goes
8 to someone who will.

9 MR. EAKES: Pay your taxes. That's why if
10 you have a rule that applies to all lenders, they
11 can't find another outlet.

12 MS. DAVIS: Let's take some turns.

13 MS. SCHWARTZ: Okay.

14 MS. DAVIS: I just have to add some clarity,
15 because we've brought up the tax cheat situation, and
16 I want to --

17 (Laughter; simultaneous discussion.)

18 MS. DAVIS: We do it for other reasons, ease
19 of convenience being one of them. You know, we sound
20 like we're coming at it from different angles, and I
21 still believe we all have this same best interest of
22 the consumer, giving them credit, helping them get in
23 the homes and helping them succeed.

24 In the non-prime loans, there are a lot of
25 people that are in homes and are making payments, and

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1 are doing very fine and that's a very good thing. A
2 lot of what has happened over the past three years has
3 enabled them to do that.

4 I still go back to when you talk about
5 stated income. We've talked about just one of many
6 things. It's just one factor. We talk about what to
7 me is the ability to pay. We've referred to that in
8 almost every part of this conversation.

9 In order to have the ability to pay, you
10 have to have income and you have to have willingness
11 to pay. On income, we've heard Bill talk about the
12 fact that I can provide a document, does not mean it's
13 real, Okay. There is fraud. Anybody can do anything.

14 So as lenders, you have to be very good
15 underwriters. You have to be able to understand the
16 consumers that you're serving. You need to be able to
17 understand what Pablo said, is that reasonableness.
18 Is that reasonable? Is the person that is in a low to
19 moderate income job and it disclosing an unreasonable
20 amount of income, does that make sense? Do all of the
21 factors together in this picture make sense?

22 Not just one in isolation, but all of them.

23 I think we are making more out of stated income than
24 maybe really is necessary. I think there is a point,
25 a place for it. I think there are concerns relative,

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1 in terms of our bright line, of where we said we're
2 really uncomfortable because there's not enough
3 support under a 620 FICO. But I think we're going a
4 step too far.

5 GOVERNOR KROSZNER: This might be a good
6 transition, because I think you're right. There's a
7 very close relationship between some of the things
8 we're discussing right now and Janis had mentioned
9 this as an issue.

10 The ability to document may also have
11 something to do with affordability of products that
12 are being offered to people. That was one of the last
13 issues that I want to discuss.

14 Something I did want to make sure that we
15 came back to, because it was mentioned just briefly,
16 is the relationship between risk layering and other
17 affordability or risk layering and documentation,
18 because I think that's one of the challenges.

19 It's not just that, you know, you get the 80
20 percent loan, but it's also when you do the 80-20, and
21 have that other piece on it. That poses a lot of
22 challenges to people, when they really have no skin in
23 the game to be doing that.

24 Then if there's just slight changes in the
25 market, getting back to what Martin was just talking

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1 about, very slight variations in the market can lead
2 to very different behavior, than if you don't have
3 that same kind of risk layering.

4 So there might be some sort of interesting
5 interaction between risk layering and -- affordability
6 issues and risk layering and documentation. But I
7 just wanted to sort of move in, not say completely
8 move away from the stated income and low documentation
9 ideas, because I think they're related, but to move us
10 a little bit towards the broader ability to pay and
11 affordability discussion.

12 MR. EAKES: The risk layering is very hard
13 to do. It makes very good sense to have in
14 examination guidance, because then you can go in and
15 check, line by line. It's very hard to say, in a
16 bright line rule, when you have four of the five
17 possibly bad features, or you can have two of the
18 five.

19 It doesn't work for a bright line rule
20 standard. I think risk layering, it's a different
21 discussion in a different context.

22 MS. COHEN: Well, speaking of risk layering
23 and no doc loans, one of my favorite recent examples
24 of this issue is a self-employed couple. They're
25 lobstermen in Maine. They've got a broker fee of

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1 5,000, and a yield spread premium of 8,000 bucks, an
2 inflated appraisal, an inflated title insurance, and
3 their monthly payment now is more than their income.

4 They're self-employed. So they have to pay
5 for their boat and their, you know, lobster cages and
6 all the other things. So we have a problem, and if we
7 can't resolve this through a checklist, as Martin just
8 described, the source of the problem in this loan is
9 that it's a no doc loan.

10 Because if you actually look at what the
11 people could afford, they never would have gotten the
12 loan to begin with. We separately need to resolve
13 inflated appraisals, but they're not unrelated.

14 What Janis was talking about before makes it
15 extremely clear. You can document unconventional
16 income, and the flip side of not documenting
17 unconventional income is that it is regularly
18 falsified. There are lawyers around the country who
19 can tell you that on a routine basis, they see Uniform
20 Residential Loan Applications, which by the way is
21 many more words and many more syllables than anyone
22 can understand. Maybe you can compensate with a
23 disclosure.

24 Where income is falsified, babysitting
25 income, rental income, that is routine. So it is

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1 incumbent upon the Fed to some way to create a rule
2 that says you have to verify that income. It is
3 without requiring verification of that income, you're
4 allowing qualification of that income, and it's a
5 serious problem.

6 It is universally understood by people who
7 talk to abused consumers that no doc loans are a
8 serious root of the problem.

9 MR. BREWSTER: I'd like to respond to that.

10 I believe that -- I was actually thinking that I was
11 really gratified that people were saying that fraud is
12 Okay. Everybody was saying take this and focus very
13 clearly. You should get fraud.

14 I've seen the exposure that's out there,
15 that says if you lie on the application about
16 anything, then that's fraud. I had kind of a question
17 for Martin on that issue, which was somewhat
18 connected, on stated income.

19 One of the rationales for a stated income
20 loan is that it's easier to do it more efficiently.
21 Doesn't that argue that it should be cheaper? If it
22 was cheaper to the consumer, would that make it Okay?

23 Because I'm hearing two arguments.

24 One is that consumers will be pushed into
25 stated income loans because the price is different.

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1 But then what Alys just said, that the stated income
2 loans give consumers a choice, basically, to not tell
3 the truth.

4 And somehow, even though we have rules that
5 say that you shouldn't lie or exaggerate, now you're
6 given the freedom to state your income how you want.
7 It is freedom to lie, and I don't think that that is
8 something we can regulate.

9 There's already rules out there that say you
10 shouldn't lie, that it's a crime.

11 MS. COHEN: I'm all in favor of not lying.
12 The question really is who's lying. Now no doc loans,
13 stated income loans are known as liar loans. That is
14 the standard description of them in the industry, and
15 it's not because the borrower lies. It's because the
16 loan originator. That is the standard --

17 MR. BREWSTER: Hold on for a second. We
18 don't accept liar loans as a standard. I know we hear
19 it and Fannie Mae certainly doesn't think that that's
20 appropriate. But I understand people say that, but I
21 think that's a mis-definition. I think it's a
22 mischaracterization, because as a basic example,
23 there's lenders out there that are telling people
24 specifically that it's not a liar loan. So I just
25 want to make that clear.

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1 MS. BRAUNSTEIN: Well, my question if it is.
2 So we're not going to make --

3 MR. EAKES: If you really reach a point
4 where you think income does not correlate with
5 performance, you don't need to have stated income or
6 anything. You just stop having a form of any sort
7 dealing with income. You just do away with it.

8 And if you can save \$300 in closing costs,
9 that's \$3 million subprime borrowing, you're going to
10 have a billion dollars of potential savings that could
11 pass through to consumers.

12 The problem is that's not how it really
13 works, and without wanting to sound too moralistic,
14 that it is Southern and preachy, I heard the
15 statistics that I think that 90 percent of stated
16 income loans are exaggerated by 10 to 20 percent.
17 I've heard the statistic of 50 percent stated income
18 are exaggerated by more than 50 percent of income.

19 If we have a mechanism in place that when
20 the borrowers or originators or creditors or lenders,
21 that we are inducing people to lie routinely in
22 commercial transactions, it's not good for the overall
23 ethical standards within the industry.

24 I think that that really is what has
25 occurred over the last three or four years,

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1 particularly in the subprime market. It really it's
2 just not like, it's just a gap. It's inducing
3 dishonesty. Regardless of who you point the finger
4 at, it's not a good thing.

5 If we can say that it is irrelevant, that
6 income is not -- does not add any value over and above
7 a FICO score, then let's do a FICO score because it's
8 so cheap. But that's not really what we're finding
9 out, now that price appreciation is starting to level
10 out.

11 We're finding that income does matter, and
12 the level from these Bear Stearns reports I've seen,
13 we need later 60 percent of the loans that have stated
14 income, 60 percent of the loans in 2006 that have 80-
15 20 first and second, and as some of my industry
16 friends say, well, we call them jokingly 90-20,
17 because they were never added up to 100 percent of the
18 value. It's always 110 percent of the value.

19 You get catastrophic results from 40, 50, 60
20 percent. You get huge loans or defaults when you
21 combine those two later. You can't sustain this.

22 MR. CHANIN: Can I follow up on that, just
23 in terms of what income matters, that's kind of a
24 secondary debate. There is some question as to
25 whether income matters. But debt to income certainly

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1 matters, and there is this notion of borrower's
2 ability to repay and how you address that.

3 There have been some suggestions, and I
4 don't recall specific state laws, but certainly bills,
5 that have said a presumptively legitimate, if you
6 will, debt to income ratio of 50 percent, saying that
7 if the debt to income ratio is 50 percent or less,
8 then that loan is presumptively legitimate.

9 Some laws have said the fact that it's over
10 50 percent doesn't mean it's not valid and so forth.
11 But are there, I guess I'd like to get some comments
12 on debt to income ratios, how you measure ability to
13 repay, whether it is feasible to have a standard and
14 what the fallout might be from any such standard.

15 MR. SANCHEZ: Let me jump in here, because I
16 just don't want to let that comment that it's the loan
17 officers out there are the liars, etcetera. I think
18 we bear a level of responsibility to how we do and how
19 we train our sales people and how we do it.

20 But the consumer's part of the transaction
21 too, right? And so I think we shouldn't just say this
22 is a stated income problem and it is all because of
23 the lenders and because they're all benefitting from
24 it.

25 There are folks that do this business the

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1 right way, and I just would hate to have that as the
2 last record here, that it's all the lenders' fault
3 that this is happening.

4 MR. EAKES: Harry will tell you that
5 generally, we lenders and advocates join together and
6 beat up on the brokers, right.

7 (Laughter.)

8 MS. COHEN: Pablo, I appreciate that, and I
9 think there are a lot of -- I like my mortgage broker.
10 I told Harry that. I like my mortgage lender. I've
11 had some questions about some of my services.

12 I want to be very clear with people, because
13 it's been my experience that people don't understand
14 what real human beings experience when they get a
15 subprime loan.

16 So let me tell you. They don't fill out an
17 application. They don't get any documentation in
18 advance. Generally speaking, this is what our clients
19 experience. When I say "our clients," I'm
20 representing legal services lawyers all over America
21 who tell me this. This is standard.

22 They show up at the closing. They don't
23 read any of the papers. They generally have an oral
24 experience; that's what happens. They don't know, for
25 the most part, that their income is falsified because

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1 they haven't read the written or the typed version of
2 the application.

3 They didn't get an estimated TILA, for the
4 most part. If they did, it's a day in advance, and
5 then they sign on the dotted line. Sometimes, it's on
6 the side of the road on top of a car or at a diner, or
7 in their living room where they're busy showing their
8 children's pictures to the broker and the lender who's
9 in their living room.

10 So we need to think about what the real life
11 experience is of somebody when we're talking about
12 what's happening.

13 MR. SANCHEZ: And I would agree with that.
14 But I will tell you this, right.

15 MS. COHEN: And Harry may ask you that.

16 MR. SANCHEZ: That's not the preponderance
17 of people's experience. I grew up in this business as
18 a non-prime loan officer, right. The very first
19 mortgage I ever did was for a person who got into debt
20 a little bit over her head. All the banks said to her
21 no, we're not going to help you. It was part of a
22 consumer finance organization. We consolidated her
23 debts, saved her \$750 a month. She baked me a banana
24 bread. I had not done a lot of loans. I was 140
25 pound then; I'm 240 pounds now.

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1 (Laughter.)

2 MR. SANCHEZ: Right, and it was properly
3 disclosed. She knew what she was signing. So I just
4 don't want to paint the whole business as this is the
5 way that it transacts.

6 MR. CHANIN: Can we move on --

7 MS. COHEN: Can I ask you a question?

8 MR. CHANIN: No. I'd like to move on,
9 because we don't have much time.

10 (Simultaneous discussion.)

11 MS. COHEN: I'm answering your question.

12 MS. BRAUNSTEIN: That was your idea of the
13 50 percent DTIs.

14 MS. COHEN: You know, I think that good
15 people can disagree about the specific question,
16 about whether there should be a cap or not. But there
17 appear to be people who can pay above DTI, and there
18 appear to be people who can pay above 50 percent, and
19 there are people who can't.

20 Whether or not you have a percentage that
21 you're looking at, if they don't have enough cash to
22 pay their exploding energy costs and their child care
23 and their transportation and their medicine, which may
24 not be insured, it's irrelevant what their DTI is.

25 So both of those analyses seem relevant.

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1 And then the question is what do you do for people on
2 social security, who are having their income grossed
3 up. I have in front of me a Wells Fargo loan. It's a
4 228 made to buyer who was on social security. It's
5 refinancing over \$10,000 in credit card debt, and
6 she's paying about 50 percent of her income, 50
7 percent of her social security, her take-home income,
8 towards her mortgage.

9 There's something wrong with that picture.
10 So the question is, how can we get at that? It may be
11 a complicated set of -- a list of characteristics,
12 rather than if you go over this number, then it's okay
13 or not okay. Not complicated, but a list.

14 MR. RHEINGOLD: And I think the point, part
15 of that point is when you figure out what that DTI
16 standard is, is that residual income is an important
17 part of that factor as well. I mean because people
18 have different levels of income.

19 So you need to actually factor not only debt
20 to income, but actually how much money is really left
21 in their pocket that can afford to pay all the
22 expenses that people have today. So I think it's not
23 just a sort of okay, this is the limit, because it
24 varies based on what people's actual income is, and
25 what income they have.

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1 MR. DINHAM: I would agree with that
2 statement, because the VA has been doing this for
3 years. The VA comes out with a 45 percent ratio plus,
4 I can't remember the exact number. You've got to have
5 so much for the husband and wife and so much for every
6 child, and you have to have leftover.

7 I don't know how that takes into account for
8 what Alys was alluding to, about the uninsured drugs
9 or anything. But at least you're doing something to
10 be sure that the person does have enough to live on
11 after they get into the home.

12 So I think that is something that we can all
13 learn to live with. I think it's something we should
14 have been looking at and we haven't been looking at.

15 These percentages, you know, we stretched
16 them when the young kids got in in the beginning,
17 where they were doing the 2836 and just starting on a
18 house, and most of them all worked out.

19 But they were still stretching on the 95
20 percent loans. So I think that if we look at the
21 backside, we'll all be a lot better off.

22 MR. EAKES: FHA and VA are really a
23 datapoint that we should look at. Their maximum debt
24 to income ratio is 41 percent, and they do this
25 residual income that both Alys and Harry are talking

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1 about.

2 They still have a default for any years with
3 the loans. It's somewhere between 15 and 20 percent.

4 So it's relatively high at 41 percent. There's no
5 way, without fixing those other income factors, that
6 you can have a 50 percent debt income limit and have
7 any kind of sustainable number of people make those
8 loans.

9 So somewhere between 41 and 50, you have set
10 debt-income. Here, I wanted to slide away to the
11 lender side. You know, I've got five billion dollars
12 of loans. I'm telling you if you put something in
13 about ability to repay, I want you to have a debt-
14 income ratio specified bright line in this rule.

15 My reason for that is I don't want to slide
16 over and have something that -- I want to be able to
17 know precisely that I've made a good loan, and that
18 you're not going to subject me to liability.

19 I would say that I believe 50 percent is too
20 high. However, within HOEPA itself it uses the 50
21 percent. The reason the different states have 50
22 percent debt-income presumption in one direction or
23 the other, is because -- and I was involved in many of
24 those laws across the country -- is because HOEPA had
25 it.

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1 HOEPA had in there a 50 percent debt-income
2 presumption. So we triggered off of that around the
3 states. Not because we really believed it was the
4 right trigger, but because we didn't feel like we had
5 another federal standard for 41 percent, which is
6 really closer to what it should be as a maximum.

7 MS. BOWDLER: I also just want to add --
8 take the time to agree with Harry, because normally I
9 just wanted a little bit of detail which I want to
10 focus on the most and I don't get that opportunity
11 often.

12 But NCLR has been doing a series of
13 roundtables across the country with the National
14 Association of Real Estate Professionals, interviewing
15 mortgage brokers, practicing mortgage brokers. We've
16 done two cities. We've got four more this month.

17 What they are telling me is that exactly
18 what Harry described, the standard best practice for
19 them, something that they would consider important for
20 any originators to be doing, which is to sit down and
21 understand the totality of the consumers' situation.
22 So their understanding of what their financial
23 situation is and what their financial goals are, and
24 then therefore their residual income and what they
25 have available.

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1 So the idea that Alys proposed, of a list of
2 minimum understanding of a person's situation, I
3 think, is important to this conversation and it also
4 goes to ability to repay as well.

5 MS. BRAUNSTEIN: Down at the industry end,
6 I'd just like to hear what you think about bright line
7 standards for ability to repay, especially if it
8 wasn't in guidance; if it was somehow codified in the
9 national rule.

10 MR. BREWSTER: There's just a lot of
11 documents on this subject. There's a lot of
12 conventional documents that have FHA-VA minimum
13 standards. I think it's going to be very difficult to
14 put it in a single standard, unless you take into
15 consideration all the other standards already out
16 there.

17 I mean a couple of years ago, when I started
18 as a loan officer, as Harry mentioned, there's 28
19 versions of the conventional standards, and
20 underwriters are just not going to go past that. The
21 business changes. A lot of the stuff that's out there
22 now is not rules-based but it's guidance-based. A lot
23 of it's automated underwriting. So there's more
24 nuances than just relying on a bright line standard.

25 MS. SCHWARTZ: I agree. I think if you do

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1 anything in rule-making, it has to be clear. It's
2 just that to be processed, there's a lot of damage
3 that could be done.

4 But it feels like it's such a dynamic
5 process to underwrite a loan. There's just so many
6 factors, so many differences that in a sense, the
7 guidance on how to deal with it might be better.

8 Just as an observation, I think if you do
9 any rule-making on it, you're going to have to be very
10 careful, like with that 2836. If that were in a rule-
11 making, you know, you would have had a far different
12 standard ten years ago. Some of us might have --

13 (Simultaneous discussion.)

14 MS. SCHWARTZ: We have had -- we do have a
15 record of brokers in the market and it's not all bad,
16 that's for sure.

17 MR. SANCHEZ: And I would add that I think
18 we have a fairly sophisticated way of looking at the
19 performance of loans, and I particularly wouldn't want
20 to see a bright line rule around 50 percent. I think
21 we need to have the flexibility. In the non-profit
22 space, I think that's very reasonable.

23 As long as we have to implement this, if we
24 believe this to be true and reasonable for that
25 consumer, then our prevailing performance, our best

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1 performance needs to be measured. We don't get to
2 just do whatever we want, right.

3 We have folks to answer to. We've got
4 profitability standards that we've got to meet, and
5 quite frankly, neither the consumer nor us would want
6 to be in a situation where we're foreclosing or have
7 somebody that's not having the ability to repay their
8 debt.

9 So I think we're fairly sophisticated around
10 being able to decide that for ourselves, as long as
11 the secondary market is for us. But we've got to make
12 sure that the income is real.

13 MR. EAKES: If we give an ability to repay
14 and a debt to income, we must take into account this
15 80-20 problem, the second mortgage. It would make no
16 sense to have a first mortgage that is whatever size
17 it took to meet an ability to repay a debt income
18 standard.

19 Yet there's this other part of the
20 transaction that is somehow behind closed doors still
21 related to it. So somehow you will need to
22 incorporate what is a dominant practice, at least in
23 2006, of the second mortgage problem.

24 MR. SANCHEZ: Martin, are you saying that
25 you feel the piggyback second is not factored into the

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1 debt to income ratio? Is that what you're saying?

2 MR. EAKES: I'm just saying it needs to be.

3 MS. BRAUNSTEIN: Absolutely, and that would
4 need to be spelled out, is what you're saying?

5 MR. SANCHEZ: Yes.

6 MS. BRAUNSTEIN: Right. So that people,
7 that wouldn't be a loophole.

8 MR. SANCHEZ: And that is something we've
9 done and have always done as part of that tradeoff.

10 MR. EAKES: Chase actually, just if I can
11 give you a little plaudit, for at least the last five
12 or six years, has had the lowest delinquency of any
13 subprime lender. So you clearly are underwriting to a
14 tighter ability to repay than virtually any other
15 lender, and we recognize it.

16 MR. SANCHEZ: Thank you for saying that.

17 GOVERNOR KROSZNER: It is noon, and that was
18 some agreement, which was good.

19 (Laughter.)

20 GOVERNOR KROSZNER: I think we've had a
21 really robust discussion of a number of extremely
22 important issues, and I really appreciate the
23 panelists for taking the time to come with us.

24 I really appreciate the honesty and exchange
25 of information that we've had. Let's break for lunch

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1 and we will reconvene promptly at one.

2 MS. BRAUNSTEIN: Can I just -- one note. I
3 just want to remind people, if you're planning to sign
4 up for the open mike session, that there's a table
5 right outside the door, and you should make sure to do
6 that. Thank you.

7 (Whereupon, at 12:03 p.m., a luncheon recess
8 was taken.)

9
10
11
12

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1 A F T E R N O O N S E S S I O N

2 1:09 p.m.

3 GOVERNOR KROSZNER: We'd like to get
4 started. Thank you. We'd like to get started again.

5 All right. So thank you very much for coming back,
6 and it's a few minutes late. What I think we're going
7 to do is go through this panel. It's going to be
8 approximately two hours and we'll end it around three
9 o'clock. We'll take a very, very short break and then
10 go to the open mike session after that and finish
11 hopefully right around four o'clock or a few minutes
12 after four.

13 So this afternoon's panel is thinking some
14 of the perspectives on rule-making initiatives from
15 the state government and researchers' perspective. We
16 have once again a superb panel. Why don't we do the
17 same ordering as last time, and start down at the end
18 with Tom Miller, who's down there?

19 From the attorney general of Iowa, and the
20 same rules. Five minutes for opening statements and
21 that will leave a good amount of time for some robust
22 discussion. Tom?

23 MR. MILLER: Thank you. Thank you very
24 much. Thank you to the Federal Reserve for embarking
25 on this process. I think it's a very important

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1 process and discussion, so hopefully the rules and
2 regulations then comes out of this.

3 Like I said, it's so important for this
4 reason, that there's really been a significant change
5 going forward in consumer protection enforcement in
6 our country, in the financial area, because of the
7 preemption that was taken by the OCC, and then
8 ultimately supported by the Supreme Court of the
9 United States in Waters versus Wachovia.

10 This has given considerably more power, as a
11 practical matter, to the federal agencies. With power
12 comes responsibility, very, very important
13 responsibility, because of what we're dealing with
14 here, people's finances regarding their homes, cars
15 and other items.

16 So we're at a very important point in
17 consumer protection in the United States. Among the
18 federal agencies, the one with the greatest power is
19 the Federal Reserve, for a whole host of circumstances
20 and legislation and history.

21 That's probably a good thing. The Federal
22 Reserve has an incredible reputation, incredible
23 staff, tradition. It has the ability to resolve these
24 questions, has the credibility to resolve these
25 questions.

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1 So in a sense, this is a fitting way to
2 wonder through this maze of preemption, and hopefully
3 come to a very good conclusion. I think that the four
4 issues that have been identified for discussion in
5 this process are very good issues.

6 The one that I'm the most concerned about,
7 as a state attorney general, is the ability to pay.
8 You know, I was the lead attorney general in the
9 AmeriQuest case, the Household case before that as
10 well. We've done, we think a lot in the subprime
11 area.

12 It's very painful to see what has happened
13 in the last couple of years. In our view, the biggest
14 trigger has been the 228s, with the ability to pay for
15 two years, not the ability to pay for the 28. That is
16 the prime driver in this enormous foreclosure mess
17 that we find ourselves in, both in terms of the people
18 involved, the borrowers and the people that own the
19 loans.

20 You know, common sense tells us that if you
21 take out a loan, you should have the ability to pay.
22 Not just for a short time, but over the course of the
23 loan. You know, some practices that hurt consumers
24 benefit the lenders, namely in the fee areas.

25 But in this concept, it works against both.

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1 It's bad for the borrower and it's bad for the
2 ultimate investor or lender, because in this context
3 certainly, when consumers are abused, when it's
4 against their interest, it's also against the interest
5 of the lending side, because the consumer ultimately
6 can't pay.

7 We have the marriage of both consumer
8 protection and safety and soundness in this criteria,
9 in this proposal. So I would strongly encourage the
10 Federal Reserve to go ahead and make strong
11 regulations concerning the ability to pay.

12 Common sense supports it; consumer
13 protection supports it; safety and soundness supports
14 it. Briefly then on the other three, all of which I
15 think are important, probably the second most
16 important, in my view, is the stated loans.

17 As a practical matter, am I moving too much
18 here? As a practical matter, there are companies that
19 don't violate the law in terms of stated loans, and
20 there are other companies that violate it very, very
21 often.

22 This is a serious problem. It is
23 potentially a criminal problem. Stated loans have to
24 be cleaned up. Whether they're totally banned or
25 whether there's tight restrictions that make sure we

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1 don't have the problem in the future, it has to be
2 done either way. The current situation is totally
3 unacceptable.

4 I do support also the changes in prepayment
5 penalties. We don't have prepayment penalties in Iowa
6 and consumers and lenders survived just fine, and I do
7 support the escrow.

8 Finally, I want to mention briefly what I
9 mentioned yesterday, and that is that in the subprime
10 market, if the major players were to all work together
11 on an ongoing basis, using our powers and anticipating
12 problems, this industry could be cleaned up.

13 When I say "the players," I mean the Federal
14 Reserve, the OTC, the OTS, the FDIC, the state
15 attorney generals and the state banking regulators.

16 This is an area where the states do still
17 have considerable power. If we developed a working
18 group where we had our most active and knowledgeable
19 people working all the time, consulting all the time,
20 what are you doing, what are the problems, what is
21 your progress, how do we solve it with the principals
22 involved at the appropriate time, we could clean up
23 the subprime market. Thank you.

24 GOVERNOR KROSZNER: All right. Thank you
25 very much. Let's move on to Mark Pearce from North

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1 Carolina.

2 MR. PEARCE: Great. Good afternoon,
3 Governor Kroszner and members of the staff of the
4 Federal Reserve Board. My name is Mark Pearce, and
5 I'm Deputy Commissioner of Banks for the State of
6 North Carolina.

7 The Office of the Commissioner of Banks
8 licenses and supervises 1,600 mortgage lenders and
9 brokers, and 17,000 loan officers. Thank you for
10 permitting me the opportunity to talk today with you
11 about opportunities to ban unfair practices under
12 HOEPA regulation.

13 I do not envy your task. We are the world's
14 best, most innovative most competitive mortgage
15 delivery system in the world, bar none. Yet market
16 forces have outpaced regulatory control and due
17 diligence systems.

18 The private market has not prevented abusive
19 lending or improvident lending. Weak underwriting has
20 led to foreclosures. Thus, the Federal Reserve must
21 weigh the pressing need to reduce abusive lending with
22 the recognition that market innovation has helped many
23 homeowners through increased choice and lower costs.

24 So my comments today I'm going to offer you
25 North Carolina's experience with these issues, and my

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1 views on the today's marketplace.

2 Despite the challenges, I believe HOEPA can
3 be updated to address problems in the marketplace,
4 without hampering innovation or access to credit. In
5 1999, my home state of North Carolina enacted the
6 first state-level supplement to HOEPA.

7 Over the past eight years, studies have
8 tried to assess the impact of North Carolina's law, on
9 both abusive terms and on access to credit. Why this
10 question is important is worth studying. It is
11 nearly irrelevant to today's debate about payment
12 shock, stated income, lack of escrows.

13 While researchers built models and while
14 policymakers debated, market participants adapted to
15 North Carolina's law, without missing a beat.
16 Unscrupulous lenders developed new tools to take
17 advantage of vulnerable homeowners.

18 Products designed for high income and more
19 knowledgeable borrowers as an exception, they became
20 the norm for borrowers with poor credit and less
21 knowledge.

22 In 2001, North Carolina enacted a
23 comprehensive licensing and supervision scheme for
24 mortgage brokers, lenders and loan officers. In the
25 interest of time, I'll refer you to my written

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1 statement on our experience in trying to regulate this
2 increasingly fragmented origination system.

3 It's been a work in progress, and it will
4 continue to be a work in progress, as the states work
5 together on a national licensing system and other
6 cooperative efforts.

7 In addition to licensing, North Carolina law
8 sets out duties expected of the mortgage originators.

9 We have principle-based standards that we use to get
10 rid of the bad apples in the marketplace.

11 However, principle-based rules alone do not
12 provide the clarity that's needed to channel
13 origination activity away from abusive loan terms. By
14 now it is old news that capital markets' appetite for
15 mortgage securities, coupled with too many mortgage
16 originators chasing too few loans, has led to poor
17 underwriting and to mortgage fraud.

18 In North Carolina, we've seen the selling of
19 loans based primarily on the initial monthly payment,
20 the use of loan products that lead to payment shock
21 two or three years down the road.

22 Subprime loans without checking borrower's
23 income, and loans with false information in the loan
24 documents. While North Carolina has suffered fewer
25 foreclosures than many other states, our evidence

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1 supports the notion that payment shock and mortgage
2 fraud are built into too many subprime loans.

3 The Federal Reserve can reduce abusive
4 lending that we have witnessed in North Carolina by
5 updating its HOEPA regulation with a few clear
6 prohibitions, such as ban prepayment penalties and
7 subprime home loans; ban most stated income loans in
8 the subprime market; require the escrow of taxes and
9 insurance in the subprime loans; and to require
10 lenders, as Tom Miller said, to consider a borrower's
11 ability to repay the loan.

12 In addition, I encourage the Federal Reserve
13 to fix the broken system of disclosures in the
14 mortgage process. On behalf of CSBS, the Conference
15 of State Bank Supervisors, I have included in my
16 testimony a discussion draft of a model disclosure
17 form that we hope has the effect of providing not too
18 much, not too little, but just the right amount of
19 information to help borrowers make informed choices.

20 Now that being said, good disclosures will
21 not prevent bad loans. Recent problems in the
22 subprime market have exposed both the strengths and
23 weaknesses of relying on markets to ensure responsible
24 lending. Lenders and some investors have paid a price
25 for irresponsible lending practices.

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1 At the same time, irresponsible practices
2 have had a devastating impact on too many families and
3 their communities. Market forces alone will not
4 protect our most vulnerable homeowners.

5 As regulators, we must use the right tools
6 at the right times, to keep pace with changes in the
7 marketplace. HOEPA did not solve predatory lending in
8 1994.

9 The North Carolina predatory lending law in
10 1999 did not solve predatory lending. The guidance
11 and the statements that we've been issuing and working
12 together on, they're helpful, but they're not
13 sufficient.

14 I respectfully urge the Federal Reserve to
15 update HOEPA now, while recognizing that even these
16 measures will not be the last word on predatory
17 lending. Thank you.

18 GOVERNOR KROSZNER: Thank you very much.
19 Let's now turn to Ren Essene from Harvard.

20 MS. ESSENE: Thanks. I want to start today
21 by thanking you, Governor Kroszner and of course the
22 Federal Reserve Board, for inviting me here today.
23 I'm a research analyst at the Joint Center for Housing
24 Studies at Harvard University, which is one of the
25 nation's leading sources of information and analysis

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1 on the housing market.

2 My testimony today derives from two
3 recently-released reports. You can find them on our
4 website, that I co-authored with my colleague, Bill
5 Apgar.

6 These studies explore very specifically
7 consumer behavior and how some mortgage market
8 players, some, take advantage of consumer decision-
9 making weaknesses.

10 We also have data that looks at the segments
11 of the marketplace, and suggests that higher-priced
12 loans flow through distinct channels. In light of the
13 recent upsurge in foreclosures, there's growing
14 evidence that many families are taking on debt to get
15 mortgages that they don't understand, and that are
16 typically not suitable for their needs.

17 We looked at the economics and market
18 research, and found that consumer preferences are
19 malleable, consumers are vulnerable to outside
20 influence, consumers lack an awareness of mortgage
21 pricing, and even some of the most sophisticated
22 consumers find it difficult to shop in the complex
23 marketplace of today.

24 Unfortunately, some mortgage providers use
25 this knowledge to aggressively push market specific

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1 products that may not be in the interest of the
2 borrower. So instead of supporting an informed
3 choice, aggressive and misleading marketing can
4 actually play into a consumer's fear and lack of
5 knowledge.

6 Beyond, we look at the incentive structures
7 of mortgage brokers and loan officers, and we see that
8 some of them create additional challenges.
9 Specifically, where it relates to specific loan
10 features and terms, may result in consumers not
11 obtaining the best mortgage for which they qualify.

12 This can really worsen a consumer's economic
13 circumstance. Problems exist in the regulatory
14 structure as well. Historically, the federal
15 regulations have played an essential role in promoting
16 a fair and efficient marketplace, by clearly defining
17 these ethical industry standards and consumer
18 practices.

19 Unfortunately, some non-bank lenders and
20 brokers operate largely outside the federal regulatory
21 structure. So therefore, what we find in looking at
22 the channels is that the most vulnerable borrowers in
23 our country are less likely to benefit from federal
24 consumer protections that are generally present in the
25 prime market.

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1 So this lack of regulatory uniformity
2 actually distorts the market activity, and as less
3 regulated market segments exploit the advantage of
4 reduced regulations over their more regulated
5 competitors. So we really have kind of a lack of
6 efficiency in the marketplace right now.

7 The two Joint Center papers that I mentioned
8 earlier suggest a range of solutions, and I won't go
9 through all of those. But I'll just speak to the
10 consumer point, that letting the consumer decide has
11 distinct limitations, and efforts must be expanded to
12 guide consumers to good loans.

13 So specifically we look at how we changed
14 disclosure regulations to enhance consumer shopping,
15 and knowing that often they come too late. I'll get
16 to this in our Q and A, because I'm about to run out
17 of time here.

18 But we make sure we match it to improve
19 timing. We know that the timing issue really limits
20 the ability for disclosures to have an impact for
21 consumers in their shopping.

22 We also believe and even apply some of our
23 consumer principles to lead consumers to good loans.
24 So I think some of the suggestions around setting
25 defaults, specifically around the escrow, where you

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1 really encourage a consumer to opt-in to the good
2 choice, while allowing for opt-outs in certain
3 circumstances.

4 These are good things. It's what we learn
5 from consumer behaviors for setting defaults, and I
6 think that's a perfect example of how to set an
7 appropriate default solution.

8 Lastly, the federal government should
9 establish uniform minimum standards, while allowing
10 room for states to innovate. So whether this is a
11 standing interagency guidance to cover all lenders,
12 including non-banks, to create a floor and create even
13 competition and consumer protection.

14 We also believe that the federal government
15 should assume responsibility for licensing mortgage
16 brokers and loan originators. We think this is
17 important at this point. There's clearly some
18 problems in the marketplace.

19 At the same time, we would want to assure
20 that the federal government allows for states to
21 establish higher licensing requirements if local
22 conditions warrant, to allow the states to be the
23 place to kind of test cases, where we can analyze and
24 see how regulations can be done and learn from those
25 experiences.

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1 As the federal government does so, we should
2 make sure there's enough resources at the state level
3 to support the kind of enforcement that needs to
4 happen. Thank you.

5 GOVERNOR KROSZNER: Thank you very much.
6 Now we'll turn to Joe Mason from Drexel, someone whom
7 I have known since he was in graduate school.

8 MR. MASON: Thank you. Thank you, Randy.
9 Thank you, Ms. Braunstein and thank you to the Board
10 for the opportunity to testify today on this extremely
11 important topic of mortgage terms and regulation.

12 The overall theme of my statement today will
13 be that specific loan features and underwriting
14 practices are not per se undesirable. While the
15 borrower may not always been the best judge of
16 suitability for particularly complex loan products,
17 non-price terms like prepayment penalties and escrows
18 are valuable ways to keep borrowing affordable, while
19 stated income and no doc loans play a crucial role for
20 small business people and entrepreneurs in today's
21 credit marketplace.

22 The remarks that follow and the more
23 detailed handout at the back, pose a challenge to
24 policymakers to improve regulation without hindering
25 new financial product development and borrower

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1 flexibility, while at the same time striking a balance
2 between pursuing fraud and misrepresentation through
3 education and advocacy, and allowing individuals and
4 society to learn from their mistakes.

5 The consumer credit industry has found it
6 extremely lucrative in recent years to market on the
7 basis of payments rather than price. Consumers have
8 become comfortable with temporary use rather than
9 ownership.

10 Non-price terms like prepayment penalties
11 and escrows tend to lower loan payments to levels that
12 are accessible to consumers. While it's been standard
13 for business borrowers to choose from a menu of non-
14 price terms associated with different stated interest
15 rates, those choices are new to most consumers and
16 create new challenges for consumer credit regulation.

17 Standard MBA textbooks teach that the total
18 loan price is a function of the non-price terms, the
19 fee-based terms and the stated interest rate. When
20 the borrower agrees to forego something, like
21 prepayment flexibility, or maintains something like
22 escrow balances, they're giving up the option of
23 acting otherwise.

24 Hence, many non-price terms can be valued as
25 a foregone options. Foregone options that reduce

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1 credit risk are valuable to the lender; hence, non-
2 price terms should lower interest rates by the value
3 of the option.

4 A borrower that does not intend to move or
5 refinance during the prepayment penalty term can
6 benefit by credibly committing that intent to the
7 lender, and receive a lower interest rate in return.

8 In such cases, however, the borrower may not
9 pay attention to the size of the prepayment penalty,
10 reasoning that the probability of moving is so small
11 that the feature doesn't pertain to them.

12 Ex-poste however, the borrower may lose
13 their job or just want to refinance during the
14 prepayment penalty period. The borrower planned
15 wrong. It's important to remember, however, that the
16 prepayment penalty that some allege to be per se
17 predatory has already been offset by a period of lower
18 interest payments up to that date. Hence, the
19 borrower benefitted.

20 Escrow elections perform a similar economic
21 function. The credible commitment to timely tax and
22 insurance payments reduces monthly payments by an
23 amount equal to the value of the foregone option. The
24 borrower that does not intend to miss tax and
25 insurance payments can credibly commit that to the

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1 lender, and receive an interest rate savings in
2 return.

3 If the lender or servicer can use the funds
4 in the same manner in core deposits, the interest
5 savings to the borrower should be even greater. Many
6 new loan features are being invented that provide
7 similar tradeoffs between non-price terms and monthly
8 payments.

9 State-of-the-art products like reverse
10 mortgages and new REX mortgages pose risks that are
11 not yet fully understood, and reduce monthly payments
12 to zero and beyond. The challenge, therefore, becomes
13 how to help borrowers understand the value of these
14 non-price features, and decide which loan is right for
15 them.

16 Financial education in the U.S., even at the
17 K-12 level, is woefully inadequate. A handful of
18 banks have begun providing financial education for
19 immigrant groups, as a way to approach that new market
20 for predominantly no doc and stated income loans. But
21 there is virtually no financial education initiative
22 focused towards the elderly, who have the most at
23 stake in very complex reverse mortgage arrangements.

24 Even with education, however, consumers may
25 have difficulty understanding the value and importance

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1 of non-price terms that are appropriate for their
2 transaction. The problem is the complexity of the
3 transaction itself, combined with the relatively rare
4 incidence of home financing during one's lifetime.

5 It may therefore make sense to acknowledge
6 the limits to education and disclosure, by
7 recommending the advice of an independent third party
8 legal or financial professional in the event that
9 standard disclosure does not adequately represent the
10 risks of a particular loan product, rather than
11 prohibit such features outright.

12 Such a provision may balance financial
13 product innovation, with borrower protection, in a
14 manner beneficial to both.

15 Last, a brief caveat. No matter the
16 disclosures or provisions enacted by the Board, some
17 borrowers will borrow no matter what the terms. When
18 home price appreciation is again in the double digits
19 and income is rising, borrowers, brokers, originators,
20 investment banks and investors will not take the time
21 to properly understand the risks they're assuming.

22 Willful overborrowing is not a reason to
23 abrogate or limit contracts. Thank you.

24 GOVERNOR KROSZNER: Thank you very much,
25 Joe. Now we're going to turn to Mike Decker from the

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1 Securities Industry and Financial Markets Association,
2 which is now called SIFMA.

3 MR. DECKER: Good afternoon and thank you
4 for the opportunity to be here. The evolution of
5 mortgage securitization has been one of the most
6 remarkable developments in the financial markets over
7 the last 25 years.

8 The mortgage securities market, now the
9 largest sector of the U.S. fixed income market, has
10 brought numerous benefits to investors and especially
11 home buyers, and has reduced risks for banks, thrifts
12 and others engaged in mortgage lending.

13 The rise of subprime lending and the growth
14 in access to mortgage credit for subprime home buyers
15 wouldn't have been possible without mortgage
16 securitization.

17 Millions of eligible families have been able
18 to purchase homes as a result of subprime mortgages
19 and mortgage-backed securities. We estimate that
20 nearly 2.2 million families use subprime financing to
21 purchase their first homes between 2000 and 2006.

22 However, it has become clear that
23 underwriting standards were at times too loose at the
24 peak of the housing boom. Subprime loans that
25 shouldn't have been made were made. Subprime lenders,

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1 secondary market investors and most importantly
2 borrowers are now paying the price.

3 The market has clearly and swiftly reacted
4 to correct the excesses. This can be seen in the
5 closure of a number of subprime lenders, and
6 increasing loss rates on bonds backed by subprime
7 mortgages, which were poorly underwritten.

8 Overall, however, the subprime market has
9 worked extraordinarily well, and has served the needs
10 of homebuyers with weak credit. Clearly, the vast
11 majority of subprime borrowers are able to pay their
12 loans on time, and they have been able to achieve the
13 dream of home ownership.

14 The vast majority of subprime mortgages are
15 sold by loan originators into the secondary market,
16 and become collateral for mortgage-backed securities.

17 Participants in the secondary mortgage market
18 generally are not in positions to determine whether
19 the loans in which they invest were originated under
20 illegal, inappropriate or fraudulent terms.

21 It would be inappropriate and unfair to
22 expect mortgage wholesalers or MBS investors to serve
23 as the supervisors of the subprime mortgage market.
24 Indeed, imposing undue obligations or liabilities on
25 secondary market participants would simply drive them

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1 from the market altogether, and dry up funding for
2 subprime originations.

3 Some policymakers at the federal, state and
4 local level have supported imposing such assignee
5 liability on secondary market participants. In some
6 cases, these efforts have resulted in a total shutdown
7 of subprime lending in those jurisdictions.

8 In addition, subprime mortgage regulation at
9 the federal, state and local levels have left the
10 market with a patchwork of different and sometimes
11 conflicting laws governing liabilities for the
12 secondary market.

13 SIFMA opposes the imposition of liability
14 for illegal lending on secondary mortgage market
15 participants. However, if policymakers do impose
16 assignee liability on investors or others, observing
17 several key principles would help mitigate an
18 negative, unwanted effects, and ensure that worthy
19 subprime borrowers continue to have access to mortgage
20 loans.

21 These include, for example, providing for a
22 clearly defined national standard for subprime
23 lending, and ensuring that damages associated with
24 assignee liability would not exceed the actual
25 economic damage suffered by borrowers, among others.

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1 In recent years, some states have imposed
2 assignee liability provisions that have been based on
3 unclear, subjective standards; have imposed uncapped
4 liabilities on assignees; or have otherwise imposed
5 unreasonable burdens on secondary market participants.

6 Perhaps the most egregious example was the
7 2002 Georgia Fair Lending Act, which included several
8 provisions that were onerously difficult to interpret
9 or apply, and which imposed potentially unlimited
10 liability on assignees.

11 The result of that action was a virtual
12 shutdown of the subprime lending business in Georgia,
13 unless the law was amended the next year. In addition
14 to ensuring that assignee liability standards are
15 clear, objective and reasonable, SIFMA has views on
16 several other policy responses to current issues in
17 the subprime market.

18 For example, we encourage loan servicers to
19 employ flexibility, as provided for in loan and
20 servicing contracts, and in accordance with applicable
21 law and accounting standards, to help borrowers in
22 trouble avoid foreclosure.

23 Indeed, we have been promoting steps that
24 can help keep families in their homes. These might
25 include alternative repayment plans, forbearance

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1 agreements and loan modifications.

2 No one benefits from foreclosures, and it is
3 in the interest of both borrowers and lenders to try
4 and keep homeowners in their homes. However, we
5 strongly oppose governmentally mandated forbearance or
6 loan modification. Such actions would impose
7 unreasonable penalties on mortgage investors, not
8 responsible for how loans were originated, and would
9 threaten the legal and contractual underpinnings of
10 securitization and reduce the willingness and ability
11 of the secondary market to finance mortgage lending.

12 We also oppose the imposition of suitability
13 standards applicable to mortgage lending, and we
14 oppose regulatory restrictions on specific mortgage
15 products. Suitability is inherently subjective, and
16 would be too difficult to apply in the context of the
17 lender-borrower relationship.

18 Restricting particular mortgage products
19 could prevent lenders from offering borrowers
20 mortgages that best meet their needs.

21 SIFMA is committed to helping policymakers
22 at all levels of government address current issues in
23 the subprime market, in a way that preserves mortgage
24 lending for families with poorer credits.

25 Thank you again for the opportunity to be

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1 here. We'll be submitting a written response to the
2 specific questions raised for the hearing topic in a
3 very short time, and I look forward to our
4 discussions.

5 GOVERNOR KROSZNER: Thank you very much,
6 Mike. Now we're going to turn to Steve Antonakes from
7 the Banking Commission in Massachusetts.

8 MR. ANTONAKES: Good afternoon Governor
9 Kroszner and Director Braunstein. My name is Stephen
10 Antonakes. I serve as the Commissioner of Banks in
11 the Commonwealth of Massachusetts. My office
12 supervises over 260 state-chartered banks and credit
13 unions, and over 2,000 licensed mortgage lenders and
14 mortgage brokers.

15 The evolution of a subprime mortgage market
16 compounded by a weakening real estate market and
17 increasing interest rates, have led to a substantial
18 number of foreclosures. These issues have been well-
19 chronicled.

20 My goal this afternoon is to focus primarily
21 upon efforts underway in Massachusetts to improve the
22 supervision of the mortgage industry and assist
23 homeowners facing foreclosure. I will also touch
24 briefly upon coordinated efforts among state mortgage
25 regulators and some actions I believe the Federal

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1 Reserve could take under existing authority to further
2 enhance consumer protection.

3 Last year, my office conducted over 400
4 examinations of non-bank lenders and brokers.
5 Examinations include a review of their overall
6 financial safety and soundness, and compliance with
7 Massachusetts and federal consumer protection laws.

8 As a result of our supervisory efforts, my
9 office issued over 100 enforcement actions last year
10 against licensed lenders and brokers. In addition to
11 our normal examination activities, we conducted a
12 sweep of 90 mortgage brokers predominantly serving low
13 and moderate income communities, focusing upon stated
14 income loans.

15 As a result of these visitations, we issued
16 several cease and desist orders, essentially
17 shuttering companies found to be overstating income on
18 loan applications or engaging in other types of
19 deceptive practices.

20 In an effort to develop a comprehensive
21 strategy to address increasing foreclosure rates in
22 Massachusetts, my office organized a Mortgage Summit
23 this past November, attended by nearly 50 individuals,
24 representing 29 government, industry and non-profit
25 organizations.

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1 Following the Summit, we established two
2 working groups, one that focused on rules and
3 enforcement and the other on consumer education and
4 foreclosure assistance. Each working group met at my
5 office for two weeks for three months.

6 Massachusetts Governor Deval Patrick has
7 taken steps to effect both the long-term and short-
8 term goals, to improve supervision over the industry,
9 and protect homeowners. He's directed my office to
10 immediately begin implementing the recommendations of
11 the Mortgage Summit Working Groups, including amending
12 existing regulations and drafting new legislation.

13 Changes in regulations will result in
14 increased net worth, bonding and experience
15 requirements for licensed lenders and brokers, and
16 increased licensing and examination fees for licensed
17 mortgage lenders and brokers, to support additional
18 examiner hires and the staffing of a mortgage fraud
19 unit.

20 Earlier this week, the governor filed a bill
21 to enact the legislative recommendations of the Summit
22 Working Groups. The bill includes provisions to
23 criminalize mortgage fraud, prohibit abusive
24 foreclosure rescue schemes, prohibit a lender from
25 making an adjustable rate subprime loan unless a

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1 consumer affirmatively opts out of a fixed rate
2 product and presents a certificate indicating that
3 they've received home buyer counseling, and will also
4 establish a central repository of foreclosure
5 information at the Division of Banks to enable my
6 office to track foreclosure data by product,
7 geographic region, originator, broker and lender.

8 In addition, the administration has already
9 testified in favor of bills to license mortgage loan
10 originators and extend provisions of the Massachusetts
11 Community Reinvestment Act to certain mortgage
12 lenders.

13 In order to provide immediate assistance, my
14 office has also, on a case-by-case basis, sought
15 delays in the foreclosure process from mortgage
16 lenders and mortgage services for any Massachusetts
17 homeowner who files a complaint with my office.

18 The goal is to provide a short amount of
19 time to allow my office to review complaints, refer
20 homeowners to reputable home ownership counseling
21 firms, and encourage mortgage lenders to utilize this
22 time to work with homeowners who are unable to make
23 their mortgage payments. To date, we have fielded
24 over 400 calls from Massachusetts residents.

25 In recent years, state mortgage regulators

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1 have also been working collaboratively to improve
2 supervision of the residential mortgage industry.
3 Several high profile nationwide settlements have
4 returned nearly one billion dollars to consumers.

5 In addition, through the Conference of State
6 Bank Supervisors and American Association of
7 Residential Mortgage Regulators, three years of work
8 have gone into the development and implementation of a
9 nationwide database of mortgage professionals.

10 This system will provide a national
11 repository of licensing and enforcement actions, and
12 is scheduled to be launched on January 1st of 2008.
13 Finally, over 40 state mortgage regulators have either
14 adopted or are in the process of adopting guidance
15 similar to federal interagency guidance on non-
16 traditional mortgage loans. Similar action is
17 expected once the statement on subprime lending is
18 finalized.

19 Based upon my experience as a state
20 regulator, I believe there are areas where the Federal
21 Reserve Board could use its broad rule-making
22 authority to ensure one set of rules exist throughout
23 the country, relative to subprime mortgage lending.

24 Respectfully, I would recommend that the
25 Board consider the following: Prepayment penalties

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1 should expire at least 30 days prior to the first
2 adjustment period for subprime adjustable rate
3 mortgage loans.

4 The Board should use its broad authority
5 under HOEPA to ensure that all creditors abide by
6 prepayment penalty limitations applicable to them,
7 regardless of whether they're state or federal laws.

8 The Board should require escrow for taxes
9 and insurance for all subprime mortgage loans, with
10 the ability of the borrower to affirmatively opt out.

11 The Board should consider adopting a rule whereby
12 consumers qualified for subprime credit would normally
13 receive a 30-year fixed rate, fully amortizing, full
14 documentation loan. An affirmative opt-out and
15 completion of counseling would be required for the
16 subprime borrower to apply for the subprime loan,
17 which either features an adjustable rate or a negative
18 amortization or less than full documentation of
19 income.

20 Finally, the Board should require lenders to
21 underwrite all subprime and non-traditional mortgage
22 products based upon the fully-indexed rate, and based
23 upon a fully-amortizing payment schedule.

24 I appreciate the opportunity to testify this
25 afternoon, and look forward to your questions.

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1 GOVERNOR KROSZNER: Thank you very much,
2 Steve, and also Steve is our representative on the
3 FFIEC, the regulatory body or the body that
4 coordinates among the federal regulators and the
5 recent regulatory relief bill included many of the
6 states on there. We're very pleased to have Steve as
7 part of that.

8 We're also very pleased to have Lori Swanson
9 with us back again. She's a part of our Consumer
10 Advisory Council, but I just want to do something.
11 But unfortunately, she decided that Minnesota was
12 where she needed to be, and she's now the attorney
13 general of Minnesota. Lori?

14 MS. SWANSON: Governor Kroszner, Director
15 Braunstein, Board staff, thank you for the opportunity
16 to appear today on this important topic.

17 I think it's important to put into context
18 what we're here about. You know, mortgage is the
19 largest financial transaction for most Americans, and
20 the American dream of home ownership has been the way
21 that most middle income Americans have built a nest
22 egg.

23 Yet today, many of our neighbors live
24 paycheck to paycheck. They can't work harder, spend
25 less or save any more. That makes them particularly

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1 vulnerable to surprises in their mortgage transaction,
2 like exploding interest rates, hidden prepayment
3 penalties our undisclosed payments.

4 It's also important to recognize that
5 there's an unlevel playing field between the borrower
6 and the mortgage lender. Anybody who's ever attended
7 a mortgage closing understands the blizzard of paper
8 work put before the borrower. But that gets stacked
9 against the home owner and some untrustworthy lenders
10 and brokers use that stacked deck to their fullest
11 advantage.

12 Documents uncovered during our investigation
13 of one company describe the sales environment of the
14 lender as a "boiler room." A manager in another
15 lending institution told his brokers "We're all here
16 to make as much money as possible, bottom line.
17 Nothing else matters."

18 Our office, along with Iowa, was one of the
19 lead states and three of the country's biggest
20 mortgage lending enforcement actions including FAMCO,
21 Household Finance and AmeriQuest. Those cases
22 involved such abuses as misleading borrowers into
23 purchasing teaser ARMs with exploding interest rates;
24 forcing borrowers to stay in expensive loans through
25 costly prepayment penalties, and placing borrowers in

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1 stated income loans, in which the lender fabricated
2 borrowers' income or assets.

3 You know, some subprime lenders like to
4 claim that they do these things to help borrowers
5 achieve the American dream of home ownership. I know,
6 however, that in many of the most abusive loans,
7 they're actually refinancing loans where the person
8 already had a mortgage and already had a home, and in
9 fact many of those are sold as cash-out refinancings,
10 where the borrower is encouraged to use the loan
11 proceeds to pay off things like credit card debt.

12 I would urge the Board to adopt substantive
13 regulations to help address the predatory mortgage
14 lending crisis. In Minnesota, I put together a
15 predatory lending study group comprised of bankers and
16 business people, legal experts and policymakers, to
17 recommend reforms in this area.

18 It resulted in state legislation, which was
19 enacted into law this spring, which covers really all
20 of the main topics for today's hearings. I would urge
21 the Board to use its regulatory authority under HOEPA
22 to similarly regulate these practices.

23 I caution the Board that enhanced
24 disclosures to the loan are not enough. It's very
25 easy, given the complexity of a mortgage transaction

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1 as I described it, for a broker or lender who's bent
2 on misleading a borrower to do so, regardless of the
3 disclosures. I think there is a need for substantive
4 regulation.

5 I'd like to briefly touch on some of the
6 main topics for today's hearing. With regard to
7 stated income loans, we've seen in Minnesota and
8 around the country serious abuses with stated income
9 loans. In my state, we see brokers falsify
10 applications to claim that people in the 80's hauled
11 in cash by making birdhouses they didn't make,
12 cleaning homes they didn't clean. We had a gardener
13 in his early 20's made six grand a month as a
14 landscape engineer. That a suburban couple made money
15 renting out an apartment in their home of their
16 basement that they didn't have.

17 It's no surprise that borrowers, who are put
18 into products because of that kind of activity,
19 default because they can't afford the monthly
20 payments. The Minnesota legislation prohibits loans
21 based merely on a statement by the borrower of his
22 income or net worth.

23 Borrowers and lenders have to verify the
24 borrower's income and assets by reliable documents
25 like tax returns, payroll receipts or bank records. I

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1 frankly think it should be a no-brainer for a lender
2 to verify in some way the income and assets on an
3 application, at least by looking at historical tax
4 returns, to make sure that the applicant has in the
5 past earned something in the ballpark of what they put
6 down on the application.

7 I'd encourage the Board to similarly look at
8 banning stated income loans in the subprime market.

9 With regard to borrowers' ability to repay,
10 far too many mortgage loans have been sold with little
11 or no regard to the borrowers' ability to repay the
12 loan with little or no underwriting. The Minnesota
13 legislation requires brokers and lenders to verify the
14 borrowers' ability to pay, not just the principal but
15 also the taxes, insurance and the like. The lender
16 must confirm that the borrower can repay not just the
17 initial payments but also the payments when the price
18 spikes occur. I would also urge the Board to adopt
19 similar regulations there.

20 In my state, we have banned prepayment
21 penalties for subprime mortgages, which can oftentimes
22 trap people into an unsuitable loan, because they
23 can't afford to pay the prepayment penalty.

24 The Minnesota legislation is a good step,
25 but we need the Board's help to fully address this

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1 issue. The recent U.S. Supreme Court decision in the
2 Waters case restricts states' ability to regulate
3 national banks and their direct operating
4 subsidiaries.

5 As a result, Minnesota's legislation doesn't
6 extend to national banks or national bank operating
7 subsidiaries.

8 Since the Minnesota legislation passed just
9 this spring, here's a classified ad from the June
10 Star-Tribune, Minneapolis' largest newspaper, that
11 says "We're hiring aggressive, paying aggressive
12 incentive bonuses. We're hiring retail mortgage loan
13 consultants. Our federally chartered status allows us
14 to continue to offer stated income and deferred
15 interest loans," because our law also bans negative
16 amortization loans.

17 So they're using essentially that Waters
18 decision to try to get around what would otherwise be
19 prohibitions.

20 So I think the states have shown leadership
21 in this area. The states also need to help the Board
22 to fully address this issue.

23 I'd like to make one final point.
24 Everything we're talking about today is really
25 prospective in nature, and we've got a lot of

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1 homeowners today who are under water, who are in
2 trouble. I appreciate and recognize that the Board
3 has taken steps to encourage lenders under your
4 supervision to work with borrowers to reach effective
5 loan restructurings.

6 In my office, we're doing the same thing,
7 working with lenders and consumers. We'd just urge
8 the Board to do anything in its power to continue to
9 do that, and take that position.

10 I believe that the financial institutions
11 that helped create this problem, either by writing
12 abusive loans or providing the financing that enabled
13 them to occur, do have the responsibility to work with
14 the borrower to help solve the problem. I thank you
15 again for the opportunity.

16 GOVERNOR KROSZNER: Well, thank you very
17 much again for all the excellent presentations, and
18 for keeping to the time limits, so that we can have a
19 good, robust discussion once again.

20 I think where we want to start off is where
21 we ended in the discussion this morning, in thinking
22 about consideration for borrowers' ability to pay.
23 This is a subject that a number of you had mentioned,
24 and that's one of the things that Lori had concluded
25 with.

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1 So I want to explore that a little bit
2 further, both what is being done in the different
3 states, and we would like to see what's being done at
4 the different state levels and what is available under
5 HOEPA.

6 I don't know who wants to sort of start off
7 with that. Probably one of the representatives from
8 the states might be --

9 MS. BRAUNSTEIN: Yes. We're particularly
10 interested in how you define that in your state
11 statutes, and how you structure it, so that to put
12 some certainty some markets for the industry, so they
13 will know if they're meeting the criteria or not.
14 What are the statutes in this area? Lori, do you want
15 to start?

16 MS. SWANSON: Yes, I'd be happy to. In our
17 state, we do have a couple of different ways in the
18 Minnesota legislation. First, as I mentioned, we ban
19 purely stated income loans, no documentation loans.
20 Essentially, the state legislation says if you're
21 going to make and arrange a mortgage transaction,
22 you've got to in some way verify what is put down on
23 the application. You've got to verify that the
24 borrower really has the income, really has the assets.

25 I'll note the argument that folks on the

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1 other side will make is well, with regard to stated
2 income loans, that these loans have often been used
3 for people who are self-employed, who maybe don't have
4 the reliable stream of income.

5 We've seen case after case through my office
6 where people are, you know, subprime borrowers who do
7 have a job and put in stated income loans, and it has
8 allowed widespread fraud and abuse.

9 The other point I'd make on that regard is
10 that sometimes that self-employed argument, the real
11 argument that I heard in the Minnesota legislature was
12 well gee, for a self-employed person may really be
13 pulling in 150 grand, but they've got so many
14 writeoffs. The bottom line is their tax return they
15 may only be paying taxes on 50.

16 Well, I don't think the government ought to
17 be in the business of helping people essentially cheat
18 on their taxes. So I think that argument sort of goes
19 away.

20 We also look at ability to repay by
21 basically saying you've got to look at, you know, the
22 ability to pay the fully-indexed rate and a repayment
23 schedule, which is full amortization over the life of
24 the loan. So it can't just be can they repay the loan
25 at the initial teaser rate, but can they repay when

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1 that rate is reset?

2 That's really how we address it through the
3 state legislature.

4 MS. BRAUNSTEIN: So you didn't -- Lori, you
5 didn't set thresholds for debt to income ratios or
6 anything like that?

7 MS. SWANSON: We did not. The other
8 standard we put in place in the state law, recognizing
9 that we did have the authority to regulate the broker,
10 a duty of agency on the broker, much like the kind of
11 suitability standard or fiduciary standard that an
12 insurance agent would have or a securities
13 representative would have.

14 That requires that before the broker can put
15 somebody into a loan, they have to do -- ensure the
16 suitability or there's some tangible benefit to it.
17 But we don't have a bright line standard.

18 GOVERNOR KROSZNER: And what has been the
19 consequence of this, because certainly one of the
20 concerns has been, and it was raised in some of the
21 discussion, is that I think that these kinds of
22 standards potentially can impinge on responsible
23 lending, not just irresponsible lending?

24 MS. SWANSON: The law has just now passed
25 this spring, and so it's yet to be implemented.

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1 MR. PEARCE: I wanted to say something.

2 GOVERNOR KROSZNER: Go ahead, Mark.

3 MR. PEARCE: North Carolina hasn't enacted
4 any legislation on this yet. I'd just make two quick
5 points. The first is for HOEPA, I would encourage you
6 to have a bright line rule, some sort of safe harbor
7 that -- I think DTIs are good and what the number is.

8 You know, in some ways you all address this
9 in your 2001 revisions to HOEPA, and so in some ways
10 moving that forward or expanding that I think is a
11 good idea.

12 We already have, we've worked together on
13 guidance, that already says that one of the things to
14 be made was the ability to repay. That guidance is
15 principles-based, and I know you all are working on
16 enforcing that and at the state level, we're working
17 on enforcing that as well.

18 So finding opportunities to work together,
19 to make sure we're enforcing that consistently is
20 something we need to work on outside this meeting.
21 But I think -- so there's room for principles-based,
22 but I think HOEPA needs to be clear.

23 GOVERNOR KROSZNER: Tom?

24 MR. MILLER: We don't have legislation
25 either. You know, what I think is obviously the

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1 starting point is there has to be something general,
2 at least, that says the ability to pay extends
3 throughout the duration of the loan.

4 How that's -- excuse me. I'm recovering
5 from a little spring cold that extended. How that's
6 actually implemented and whether there's specific hard
7 and fast rules, you know, I guess we haven't as AGs
8 gotten to that point, where we're at is the basic
9 concept that ability to pay has to extend throughout.

10 It has to extend to the whole industry.
11 Whatever we as a group do and you do, it has to extend
12 to the whole industry.

13 GOVERNOR KROSZNER: Well, one part of this
14 important point, which gets to your point also, but is
15 this best done through coordination with the states,
16 through if the federal regulators put up guidance that
17 we then coordinate with you, to try to implement at
18 the state level, or is this something that you think
19 needs to be done through a particular HOEPA rule, that
20 may be more challenging to do in a principles-based
21 way than the guidance would be?

22 MR. PEARCE: For me, it would be the latter.
23 I think HOEPA needs to set out some bright line
24 standards to move the marketplace. I think state and
25 federal regulators should work together on enforcing

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1 the fuzzier principles-based standard, to address, you
2 know, within the boundaries.

3 I think HOEPA's boundary just needs to move,
4 to get -- to make sure that there's some limits that
5 we can say, and I think HOEPA now has a 50 percent
6 number, and I think that's -- I've seen very few loans
7 that I thought had a DTI of 50 percent, that the
8 borrower had actually a meaningful ability to repay
9 the loan.

10 So I think setting the boundary in HOEPA and
11 then using our guidance collectively to address the
12 cases where somewhere less than that is probably the
13 right outcome.

14 GOVERNOR KROSZNER: So I just want to drill
15 down on this a little bit more, and then I can get
16 others. So what specifically more do we need to do,
17 since we have the 50 percent already. What more do we
18 need to do?

19 MR. PEARCE: So I would say the ability to
20 repay needs to be, you know, part of the unfair and
21 deceptive trade practice or unfair practice, to
22 originate a loan without concern for the borrower's
23 ability to repay the loan at a fully-indexed rate,
24 fully amortizing payment schedule.

25 Then you could say if the debt to income

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1 ratio is less than 50 percent, then we'll send you
2 that rule. So that's very clear. Everyone can
3 understand how that operates in the marketplace, and
4 that applies to all institutions across the state,
5 across the country.

6 GOVERNOR KROSZNER: Steve, I want to make
7 sure to hear from you on some of these things. But I
8 want to hear your perspective on this.

9 MR. ANTONAKES: No, I agree. I think it
10 would be better under HOEPA, and would be, you know,
11 addressing loans beyond high cost loans, because
12 frankly in our experience, we have a predatory lending
13 law as well, is that once you pass the threshold, no
14 one makes high cost loans anymore.

15 They have means of getting below those
16 thresholds. The ability to repay is, you know, to the
17 fully-indexed rate, a fully amortizing payment, you
18 know. I don't see why it can't be further enhanced by
19 being included in the reg, as opposed to just a
20 guidance, which may be interpreted by some as best
21 practices as opposed to a rule to be followed.

22 GOVERNOR KROSZNER: Mike?

23 MR. DECKER: I'd just make two points, I
24 think. First, if there was going to be some kind of
25 an ability to repay provision implemented through

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1 HOEPA, we'd advocate that it be some kind of a clear
2 bright line type rule, that both originators and
3 secondary market participants could easily determine
4 that the loan was in compliance through the kinds of
5 information that generally follows the loan from one
6 owner to the next.

7 The other point that I'd make is with
8 respect to HOEPA generally, and with respect to
9 implementing regulations through HOEPA, relatively few
10 loan originators actually make HOEPA loans. The
11 standards are such that if a lender can't structure a
12 loan such that it falls outside of HOEPA, often the
13 loan just doesn't get made.

14 So if you restrict the kinds of loans that
15 are defined, if you further restrict the kinds of
16 loans that are defined under HOEPA, and lenders can't
17 find a way to structure loans outside of HOEPA, you'll
18 have some borrowers that simply won't get lending, and
19 that should be a consideration.

20 GOVERNOR KROSZNER: I want to turn to the
21 academics, because I know there's been a lot of study
22 of what different states have adopted and changed some
23 of their regulations, and to get at exactly these
24 kinds of issues.

25 What sorts of provisions seem to have worked

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1 and haven't worked in trying to provide safe harbors
2 and, in some cases, unsafe harbors, which have led to
3 a reduction of both irresponsible lending but
4 potentially responsible lending?

5 MR. MASON: Well, getting back to --
6 starting with DTI, I want to say I would beware of
7 applying a bright line to a fuzzy concept, because the
8 concept is debt today is what's in question. This
9 subprime thing we have, which doesn't build equity
10 ownership in a house, is something we're calling debt.

11 I would be very wary of the composition of
12 debt in the consumer's portfolio. Are they leasing a
13 car and renting furniture, and have a large balance on
14 their credit card, which is growing a couple of
15 hundred dollars a month?

16 That person is never going to come back from
17 their already high DTI ratio, and they're not a stable
18 borrower. So I think that may differ from a person
19 who has a high DTI ratio and is buying their car, has
20 three years left on some student loans, and is just
21 finishing their degree or something like that.

22 There's a point that you could see this
23 person extinguishing their DTI, going down some time
24 and building into a creditworthy individual. These
25 are products designed to build a credit portfolio, to

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1 recover, to increase your credit rating or recover
2 your credit rating.

3 As such, they're part of a financial plan.
4 I think one of the key safe harbors here is to treat
5 this as a financial plan, and seek the advice of
6 someone like a financial planner and allow the
7 borrower to do that.

8 One of the key ways to do that -- most
9 everybody's touched on this today, so I won't spend a
10 lot of time, is have a commitment period, something
11 like 30 days prior, where I can run that by a
12 financial planner or at the very least, my brother-in-
13 law who works in a bank, and I can talk it over at the
14 family picnic and be told that this is stupid, and I
15 shouldn't be doing it.

16 But at the closing table, I want the house.
17 The movers are waiting. I've got everything lined
18 up, the kids are excited. They've got me.

19 GOVERNOR KROSZNER: Ren?

20 MS. ESSENE: I don't know of any specific
21 studies right now. I know Aberdeen, Paint and Cross
22 and a series of four authors are currently working on
23 looking at the impacts of predatory lending laws,
24 state laws and trying to understand how that's
25 impacted the marketplace.

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1 So I think those are forthcoming and I think
2 it will be really interesting to see what the effects
3 are, and if there's going to be some real live data
4 this fall, I know, with our fall credit symposium.

5 What I would say, it's very heartening to
6 hear some of the state players talking about this
7 coordination issue between the federal government and
8 the states, because I think one of the dynamics we
9 need to really be focused on is this issue of high
10 roader and low roader lenders.

11 I think we heard earlier today from many of
12 the high roader lenders, and so we got to hear, you
13 know, some of the efforts that Faith and other folks
14 are putting forward, that are very positive in the
15 marketplace, are good models for what should be
16 happening.

17 Unfortunately, what we know is that there's
18 also low roaders in the marketplace as well, and that
19 it's challenging for the industry to kind of self-
20 regulate. There's really a collective action problem,
21 where you have one person who's engaged in bad
22 behavior, and it's very hard for the rest of the
23 industry to sanction that player.

24 So I think that's the step for regulation to
25 come in, is to try to create this even playing field.

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1 I know that we found, you know, that high- priced
2 lending, specifically looking at that three percent
3 above Treasury, that about 12 percent of the industry
4 is really making the lion's share of most of those
5 loans, where they are specialists, high-priced
6 specialists that make over 50 percent high-priced
7 loans.

8 So I think we need to be focused then on
9 where that mischief is and create these kind of
10 minimum standards. I think the guidance is a great
11 step in the right direction, and I think the question
12 is how to make that both enforceable and even across
13 the marketplace.

14 GOVERNOR KROSZNER: Great. Does anyone have
15 anything to add on this, because I want to move on to
16 prepayment.

17 MR. CHANIN: Let me raise this one thing.
18 It's clear, to the extent that any rules adopted in
19 this ability to repay, that they have to be specific
20 and very clear, someone knowing in advance whether
21 they've complied or not.

22 One of the difficulties is just taking, for
23 example, debt to income ratio. Fifty percent seems
24 to be a pretty clear test. That is, if it's 50
25 percent or less, then you know when you comply. But

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1 if you dig down to the details, it becomes very, very
2 complicated. You start looking at underwriting.

3 For example, if you have a car loan and you
4 have two payments left or one payment left, do you
5 consider that in the 50 percent debt to income ratio.

6 Or, if you have a bonus, do you consider that?

7 If a lender is unable to know with some
8 degree of certainty whether those count or don't
9 count, it's going to be very difficult for the market
10 to function effectively. So I guess I would not
11 relish the notion of having a very long list of every
12 different type of debt, income and so forth to address
13 in any rule.

14 So I'd ask for any suggestions or if any
15 states or others have had any experience with that,
16 how they dealt with those types of issues.

17 MR. MILLER: You know, perhaps we could
18 check with our colleagues. This is obviously a very
19 important question. Maybe we can survey the AGs and
20 also the banking superintendents, to wrestle with this
21 a little more.

22 Because I think it is really important that
23 we have a rule or regulation that applies to
24 everybody, and that we all together then to enforce
25 that.

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1 GOVERNOR KROSZNER: Certainly, I think just
2 as a reminder, but the record is open until August 15th
3 for getting comments, and we're always happy to have
4 comments. But it would be particularly valuable to
5 have something by that August 15th deadline. Yes, Joe.

6 MR. MASON: I'd just like to make one
7 comment before we move on, because it seems like we've
8 talked a little bit about stated income mixed in with
9 affordability. So tell me if I'm jumping ahead here.

10 But I wanted to make a note about income.
11 While in our minds it all seems like income definitely
12 correlates with affordability, it does in our minds.
13 But our minds aren't running the underwriting and
14 pricing process.

15 We know that what's received by the broker
16 is an income statement of some sort. I can print out
17 from TurboTax different tax forms with different
18 income levels on them, and I can sign them and present
19 them as the taxes that I filed this year.

20 People do have unstated sources of income.
21 Waiters, bus boys, that kind of thing. So there's a
22 lot of noise in the income that you get. We've talked
23 about that. But what we haven't talked about is how
24 it plays into the credit scoring model, because the
25 credit scoring model is what's grading the credit and

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1 giving out the loans.

2 When we get to that point, the FICO score
3 gives about 80 percent of your predictability. In
4 fact, the income is correlated with protected class.
5 So what we've done on the model side is we've had to
6 wash out the statistical predictability of the income,
7 such that it creates just a small, marginal effect.

8 So while it makes sense that income
9 correlates, there's a lot of noise in income and in
10 the models. It cannot be used, because it runs afoul
11 of fair lending.

12 GOVERNOR KROZNER: Well actually, what we
13 could do is rather than turn to prepayment issues,
14 since you've brought up the income issues, that we
15 might segue into that piece.

16 So as Lori had mentioned, you've gone
17 towards, I guess, an actual prohibition on no doc and
18 stated income loans. I wanted to understand that a
19 little bit better in practice, what kind of standards
20 you either have in mind or have started to see in
21 practice, for providing appropriate documentation?

22 Because that's one of the challenges that we
23 talked about in the earlier panel, with providing --
24 if we are going to be moving away against low or no
25 doc loans, I want to make sure that people who do have

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1 incomes but not incomes that are documented in the
2 traditional way, still have access to credit.

3 MS. SWANSON: Yes, I think that I can jump
4 start it. We allow some flexibility in our law for
5 lenders to deal with those kind of individual
6 situations, recognizing that we're not a homogeneous
7 country and people do make a living in different ways.

8 So although we do ban purely no
9 documentation loans or stated income loans, we do
10 require the lender to look at some documents, again to
11 show that the borrower really does have assets and
12 income in the ballpark of what is represented on the
13 application, and that can be various types of
14 documentation.

15 It could be tax returns. It could be
16 payroll receipts; it could be a bank statement. We
17 allow flexibility in individual cases, for the lender
18 to make some determination of what that documentation
19 should be. The law basically says it has to be
20 reasonable, and it ought to be reasonable for the
21 lender to rely on it.

22 But again, recognizing there are these types
23 of different situations out there. But I do want to
24 emphasize. I think it is very important for the Board
25 to take some action in the stated income arena. I

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1 just think that the no documentation loans have led to
2 very, very real abuses that we've seen through these
3 three general enforcement actions and other cases that
4 we've taken.

5 I think it's important to act, using the
6 HOEPA authority. As I also mentioned, if you look at
7 the want ads in the Minneapolis paper, people are
8 trying to get around that law. So that's where a
9 federal action could be very, very helpful in this
10 area. Thank you.

11 MR. MILLER: I'd just underscore what Lori
12 said, that the stated income practice for some
13 companies, not all companies, but with enough
14 companies, has been a national scandal and it has to
15 stop. There has to be some regulation that
16 effectively stops it, something like they did in
17 Minnesota or some variation of that.

18 What we saw in our investigation, and Lori,
19 I think, mentioned a couple of the instances, are just
20 chilling. You know, looking back, it's really
21 criminal fraud. Next time around, we should use the
22 criminal statutes. But the better way is to use your
23 power to make sure it doesn't happen in the future.

24 MS. BRAUNSTEIN: Well Lori, I just want to
25 offer one question. Do you have liability attached to

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1 your law, banning stated income loans?

2 MS. SWANSON: There is a private right of
3 action that a consumer would have against a broker who
4 violates that law, yes.

5 MS. BRAUNSTEIN: Okay, and the reason I
6 asked this because one of the things we're struggling
7 with is there is the same kind of right in HOEPA. If
8 we can't draw the bright lines, there's some concerns
9 about the industry not having certainty. It sounds
10 like you've got some fuzziness in your law about this
11 reasonable, whatever that means.

12 So are you getting pushback from the
13 industry about that or --

14 MS. SWANSON: You know no, we're not. In
15 fact, we worked in my state -- as I mentioned I put
16 together this study group to try to come up with
17 reforms, and that was bankers and lenders and, you
18 know, consumer advocates and actually worked with the
19 industry.

20 In the end, the bill was supported and
21 endorsed by the bankers association, the mortgage
22 brokers association in my state who worked with us and
23 then supported the legislation. They certainly felt
24 they could live with it. In my state anyway, they
25 supported it in the end.

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1 MS. BRAUNSTEIN: Steve, do you ban stated
2 income loans?

3 MR. ANTONAKES: We do not ban stated income
4 loans. However, we're trying to restrict their
5 proliferation, I would say. Certainly, I mean, you
6 have to, I think, realize and look at the fact that,
7 you know, incentives were created through the
8 securitization of these higher cost loans, for
9 originators to push this product, including in
10 numerous instances in which a real need to document
11 income was readily available.

12 I'm just going to give you a couple of the
13 most egregious cases that we've found in our
14 examinations. An individual who was pleased to show
15 us his due diligence program, which involved him going
16 to www.salary.com, plugging in an occupation and a zip
17 code, getting the range of incomes and multiplying the
18 high end by 125 percent.

19 This isn't something that we found by
20 accident. This was his way of showing he was doing
21 his job, Okay. Other cases. Full documentation loans
22 which had incomes of \$30,000, tucked behind the file
23 was a reduced documentation loan, with everything else
24 the same except the income is now \$65,000, Okay.

25 Cases in which 40 loans in a portfolio

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1 originated in the last year, in which everyone had the
2 same job and the same income, Okay? This is an area
3 fraught for abuse, and there has to be a means of
4 limiting, you know.

5 Stated income loans once upon a time served
6 a purpose. But they've gone well beyond that original
7 limited purpose, and they should be brought back.

8 MR. PEARCE: Yes, I mean I can chime in.
9 Again, my own story about the highway patrolman that
10 made \$22,000 a month. It's a pretty good job if you
11 can get --

12 (Laughter.)

13 MS. BRAUNSTEIN: He's getting a cut from the
14 tickets.

15 MR. PEARCE: Or a speed trap. You know, I
16 think still in the marketplace, something stated
17 income loans, the last that I looked at it, was
18 somewhere around 30 percent of the subprime market
19 still were stated income loans.

20 I don't think these are folks who are
21 working second jobs and not reporting incomes. I mean
22 I don't think we should drive our policy based on
23 people who aren't reporting income anyway.

24 But I don't think this is customer choice.
25 They're saying you know, it's too hard for me to get

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1 these -- my tax return together or my W-2 form. I've
2 seen plenty of loan files that had stated income
3 loans, that had W-2s in the file that did not match
4 the stated income.

5 So I don't think this is being driven by
6 borrowers. I think it's being driven by, as Steve
7 said, a preference in the securities marketplace for
8 stated income loans. If you look at a rate sheet for
9 -- I don't know whether this is a high road lender or
10 a low road lender, and you look at stated income. You
11 go through the chart. Stated income loans for a
12 subprime hybrid loan.

13 Borrowers could get a fix rate loan at a
14 lower cost if they brought full documentation. They'd
15 get lower cost than the initial teaser rate of that
16 loan. I do not think there are very many borrowers
17 that said "Oh, if I don't have to bring in my tax
18 forms, give me a loan that's more expensive up front
19 and will go up two years from now."

20 And who knows what interest rates might do?

21 I mean you guys probably do, but --

22 (Laughter.)

23 MR. PEARCE: So anyway.

24 GOVERNOR KROSZNER: There are two aspects of
25 this. Obviously, there's the fraud aspect, which Tom

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1 had mentioned. So clearly, if there's fraud that's
2 going on, there are anti-fraud statutes that very
3 clearly cover the type of egregious behavior that
4 you've illustrated with these examples. So obviously
5 that is something that is unconscionable and
6 fortunately is against the law.

7 So that's why I really want to understand
8 by doing something additional with HOEPA, I guess
9 these things that are clearly fraudulent activities,
10 they could be attacked through those means. I want to
11 understand the interaction between sort of extending
12 HOEPA and the existing fraud statutes, for those types
13 of things. So if anyone wants to comment on that.

14 MR. MILLER: I think that it's acting
15 earlier and being preventative, rather than having the
16 crimes take place and do some criminal prosecution and
17 try and unravel the damage that's done to everybody.

18 The idea is to have a national standard that
19 all lenders have -- are clearly on notice that they
20 have to do, and they have to watch over the people
21 that are working in their office, and to some extent
22 watch over the brokers, to make sure that these things
23 don't happen right from the beginning.

24 It's the best chance to stop the problem at
25 the greatest level.

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1 GOVERNOR KROSZNER: What about this anti-
2 fraud statute, and if a person is encouraging their
3 loan officers to do the \$22,000 a month or do some of
4 the other things that Steve was talking about? I mean
5 how is it any different if we have it in a HOEPA rule
6 than if it's clearly something that is fraudulent,
7 like it might be in these egregious cases we're
8 talking about?

9 MR. PEARCE: Stated income loans are just
10 invitations to fraud, that if you're not even going to
11 verify the income, then it doesn't matter what you put
12 down. I've had brokers tell me "Isn't that what
13 stated income means? I just state whatever income I
14 want to put on the form."

15 That broker's no longer doing business in
16 North Carolina, so that's a different story. Well
17 certainly, the states, every state I know, I mean
18 we've got a mortgage fraud bill pending in North
19 Carolina, to make it criminal, to try to increase the
20 penalties.

21 We're certainly doing all we can to enforce
22 it. We've hired more investigators. We're doing more
23 examinations to do it. But if the lending products
24 that are offered are invitations to fraud, by saying
25 you don't need to check, then I think it's creating a

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1 marketplace that will induce fraudulent behavior.

2 MR. DECKER: There have been abuses of
3 stated income loans over the last two or three years.

4 That's for sure. But if you look at the performance
5 of stated income loans over the last 10 or 12 years,
6 they've actually performed fairly well.

7 That's I think one of the effects that led
8 to the growth of stated income loans, particularly for
9 subprime borrowers over the last two or three years,
10 combined, of course, with you know, multiple years of
11 double-digit house price increases, where lenders in
12 general, some lenders in general kind of took the
13 attitude that these loans can never default, because
14 as long as the house price keeps going up ten percent
15 a year, nobody's going to be in trouble.

16 But I think prohibiting stated income loans
17 takes away from borrowers potentially in several
18 respects. The obvious case is one where a borrower
19 can't or doesn't want to document their income, and
20 if they can't get a stated income loan, they simply
21 can't get a mortgage at all.

22 But consider a hypothetical situation, of
23 somebody who's a taxi driver or a bartender, you know,
24 somebody who receives a lot of cash income and the
25 cash income varies from period to period. Perhaps

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1 they don't report it all. It's not clearly
2 documentable.

3 They have a four percent ARM that's due to
4 spike in a few months to eight percent. They want to
5 be able to refinance -- they're able to refinance into
6 a six percent fixed, but you know, they can only do it
7 as a stated income loan.

8 Well, if you take away their ability to get
9 a fixed rate stated income loan, now they're stuck
10 with their ARM, which is going to boost them up to
11 eight percent, and they're just locked in, locked in
12 for good. I think, correct me Ms. Swanson if I'm
13 wrong, but I think that the Minnesota law against
14 stated income loans applies to both prime and subprime
15 borrowers?

16 MS. SWANSON: Correct.

17 MR. DECKER: Yes. So you know, we certainly
18 wouldn't want to see that kind of an approach
19 undertaken on a national basis.

20 (Simultaneous discussion.)

21 MR. MILLER: Are you sure that there is a
22 safety valve, that really the legitimate stated loan
23 can be made under the Minnesota statute? But it
24 really has -- you have to be able to show it. You
25 have to be able to prove it.

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1 MS. SWANSON: That's right, yes. Allowing
2 the lender to have some discretion, that you can't
3 just have a no documentation loan. But it does let
4 the lender have other ways of showing documentation.

5 Again, the government is not in the business
6 of helping people cheat on their taxes, or somebody's
7 not reporting income or they're hiding assets. That
8 really shouldn't be a policy that the government ought
9 to be encouraging, in my opinion.

10 I think Governor, it is the difference
11 between prevention and prosecution. You're right,
12 there are lots of laws that prohibit fraud.

13 But at the same time, we know these stated
14 income abuses are occurring, and occurring on a really
15 widespread basis, and that the stated income products
16 have become a tool for so much abuse that the
17 borrower, frankly in some cases fraud upon the lender
18 as well, that it does make sense to regulate them as a
19 product which has been one, which has been a risky
20 product and a product that has led to abuses.

21 GOVERNOR KROSZNER: A point that Mike
22 brought up, which with the industry folks I'd like to
23 get some feedback on, is I think perhaps you can draw
24 a distinction between refinancing and the original
25 loan, because I think there had been some discussion

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1 of well, if we have, you know, if we have documented
2 income initially, and then the person has built a very
3 good payment history, in many cases people will --
4 that may be used as evidence, not necessarily
5 indirectly, but of a sufficient ability to repay,
6 particularly if it's being refinanced perhaps at a
7 lower rate than it was before.

8 Would you still want to say that even with
9 the refinancing, you have to go through the
10 redocumentation again, or would you draw a distinction
11 between the initial loan and a refinancing, in terms
12 of the amount of documentation you think is necessary?

13 MR. ANTONAKES: If you've documented income
14 once, then I don't know why you'd want to not document
15 it the second time. As Mark pointed out, you'll
16 probably get a higher rate loan. It's just not --
17 it's counterintuitive in many respects, I believe.

18 You know, we ran the statistics that stated
19 income loans that were performed 12 years ago;
20 granted, a very different market then. I'd like to
21 know of the earlier payment defaults that have
22 occurred in the past 18 months, how many were stated
23 income?

24 I'm willing to guess a fairly substantial
25 number. I don't think restricting it to refinances

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1 versus home purchases necessarily reduces fraud. We
2 also spilled out some of the very egregious cases.

3 Part of the difficulty is many folks are a
4 little smarter about cheating on the income in ways
5 that isn't so obvious to identify necessarily.

6 GOVERNOR KROSZNER: If we were to write a
7 rule that is closer to potentially having a chilling
8 effect on good behavior. So that trying to get this
9 right is always very difficult.

10 MR. MILLER: Yes. I think what we have to
11 keep in mind is that the subprime market is a majority
12 refinancing. I mean we tend to think of all these
13 home loans as putting people in their homes. But in
14 subprime, a majority, maybe 60 percent and sometimes
15 maybe higher, is refinancing, and it's primarily a
16 refinance business.

17 So I think you have to have the same
18 documentation in the refinance for that reason,
19 because a lot of them are initiated by contact by the
20 lender. The example that you cited, the person
21 building his credit, is the very unusual situation.

22 The more common situation is people call
23 them, what about your credit card debt? So with that
24 kind of volume, I think the rule has to be driven
25 towards the full documentation, whatever is arrived

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1 at.

2 Just to end the previous discussion, you
3 know, what we're asking you to do this, even though
4 there's fraud laws, because we have more respect for
5 you. We think your power is greater than these fraud
6 laws, and I think as a practical matter it is. And
7 then also it's early, it's prevention, as Lori said.

8 GOVERNOR KROSZNER: Well certainly not in
9 terms of enforcement at, let's say, the state level.
10 I mean we don't have those enforcement powers at the
11 state level. But you guys might.

12 MR. MILLER: You don't, but your initial
13 rule, you know, will carry a lot of weight, will
14 accomplish a lot of good. Do not underestimate that
15 at all.

16 GOVERNOR KROSZNER: Right. So but I want to
17 hear from you guys, but then I want to move on, to
18 make sure that we get to the other two topics. Go
19 ahead, please.

20 MS. ESSENE: Very quickly. Let me just say
21 this also points to the fact to a lack of transparency
22 in the marketplace, and so maybe the people who going
23 to have stated income loans might not know that that's
24 what they have. So that might be to have that
25 discussion of the disclosure conversation as well.

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1 GOVERNOR KROSZNER: Okay, good. Any last
2 comments on this before we move on?

3 MR. DECKER: I'll just make the point that I
4 think maybe others are sort of alluded to already. If
5 a borrower or a lender or both are intent on
6 committing fraud by lying about income, knowing that
7 that's illegal and in some cases criminally illegal
8 under current law, I'm not sure prohibiting stated
9 income loans under HOEPA is going to necessarily
10 discourage that behavior.

11 GOVERNOR KROSZNER: All right. Let's move
12 onto prepayment penalties, and certainly there was
13 some discussion that in some of the states, there's
14 been moves against prepayment. So I think it would be
15 very useful to hear about some of those experiences
16 first, and then we can talk about analyzing the
17 consequences of that. If anyone wants to talk about
18 their experiences?

19 MR. MILLER: We in Iowa have not had
20 prepayment penalties, I think, since 1978, a long
21 time. You know, we've survived quite well without
22 them. Our consumers have done Okay. The lenders have
23 done just fine.

24 Admittedly, I don't feel as strongly about
25 this provision as I do about the other two that we

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1 just talked about. But I think in terms of
2 transparency, it's important. In terms of the
3 empirical information that we received and was talked
4 about this morning, that isn't really a rate reduction
5 as a practical matter for most consumers if there is a
6 prepayment penalty.

7 That all augers for prohibiting them, and as
8 I said, it was safely done in Iowa. I would add that
9 in one of our investigations, since there were no
10 prepayment penalties in Iowa, we noticed that in
11 another abusive category, the company caught up
12 somewhat. So maybe that's the market at play, but not
13 the way we wanted to be functioning.

14 MS. BRAUNSTEIN: Are they banned, Tom, in
15 Iowa for all loans?

16 MR. MILLER: I believe so, yes.

17 GOVERNOR KROSZNER: What was that
18 alternative category, where people substituted in one
19 type of bad behavior?

20 MR. MILLER: I think it was credit life
21 insurance, I think, when that was still a product.

22 GOVERNOR KROSZNER: Other experiences in
23 other states?

24 MR. ANTONAKES: We have a lot of prepayment
25 problems in the duration and the amount. It's a state

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1 law that, in all frankness, is not followed by non-
2 state chartered institutions. Federal banks, national
3 banks don't adhere to our prepayment penalties, and we
4 think they should.

5 But you know, but our law was also written
6 in a period that predated the proliferation of 228 and
7 327 mortgages. If you look at these loans, you know,
8 they're drafted, they're created primarily to assist a
9 subprime borrower to get credit and then, you know,
10 they should be able to refinance out before the first
11 rate adjustment.

12 The reality is many of them carry prepayment
13 penalties that extend beyond that first rate
14 adjustment. That to me is unconscionable.

15 There should be a period -- if the
16 presumption is the borrower probably is told during
17 the application process, that don't worry, we'll
18 refinance you beforehand, there should be written in
19 there, a prepayment penalty if it exists at all, that
20 expires well before that first rate adjustment, to
21 give the borrower time to either refinance with their
22 existing company, or shop the loan with someone else.

23 GOVERNOR KROSZNER: And I think you said in
24 your opening remarks, 30 days?

25 MR. ANTONAKES: I would say at least 30

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1 days. I mean but a sufficient period, you know, to
2 complete a refinancing process.

3 MR. PEARCE: So North Carolina addressed
4 prepayment penalties three ways. First, for loans
5 under \$150,000, they're banned. Second, in our high
6 cost loan, the state predatory lending law, we include
7 them in the calculation of points and T's, or most of
8 them.

9 We also had in our high cost loan a separate
10 trigger, so if it's a prepayment penalty above two
11 percent for 30 months, then it also triggers the high
12 cost loan protections. I feel pretty strongly -- Tom
13 doesn't feel quite as strongly, but I feel pretty
14 strongly about this, because I think about the
15 incentives --

16 MR. MILLER: Sorry to undercut you. I mean
17 we've got to stick together in --

18 (Simultaneous discussion; laughter.)

19 MR. PEARCE: The incentives in the
20 marketplace. Prepayment penalties help fuel
21 upselling. So where a broker says hey, you know, in
22 the subprime market it's not as price-competitive.
23 People aren't shopping on rate, for the most part. So
24 the broker is the one that's actually setting the
25 rate.

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1 If lenders will not pay the premium on these
2 loan transactions unless they can be guaranteed
3 they're going to get their money back, and they do it
4 through prepayment penalties. Some borrowers pay it
5 and some borrowers don't.

6 So prepayment penalties in subprime loans do
7 create this incentive. The prime market's
8 competitive. It's also a place where you don't see a
9 lot of prepayment penalties. So it's a different
10 market between prime and subprime. So that's one
11 incentive.

12 The second is the thing about borrowers who
13 have good credit, but got into a subprime loan.
14 There are different statistics out there. Fannie Mae,
15 Freddie Mac have all, at various points, estimated.
16 We know there are some number of people, a significant
17 number of people, who have prime quality credit.

18 They get in subprime loans. If they have an
19 opportunity to refinance into a better loan, but yet
20 to do that they have to pay thousands of dollars to
21 get out of it, that -- steering into a bad loan has
22 significant economic consequences for that family.

23 The third incentive I want to talk about,
24 and I'm probably not the expert at the table. I'm
25 going to defer down to the panel on this, is in the

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1 securities market, you know, we've talked some about
2 whether people benefit from foreclosures or not.

3 Well, in the securities market, there are
4 some folks that get the stream of prepayment penalties
5 that are actually paid and collected. So if I'm an
6 investor and I get money if the loan is charged a
7 prepayment penalty, that makes loan modification
8 pretty difficult, because in loan modification, what
9 you're saying is well, we're not going to charge that
10 prepayment penalty.

11 So the servicer may have many masters
12 they're trying to please, and having prepayment
13 penalties in the subprime marketplace just complicates
14 that picture of working out loans that can be worked
15 out.

16 MR. CHANIN: Mark, can I follow up on one
17 point. The North Carolina law, I think you mentioned,
18 makes a distinction in terms of -- it bans prepayment
19 penalties for, I think you said loan amounts \$150,000
20 or less.

21 I think Minnesota takes a different
22 approach, banning them for subprime but not -- and has
23 different rules for prime. Can each of you talk about
24 -- well, one Mark, the \$150,000? Was that intended to
25 be some sort of proxy for subprime, or what was the

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1 rationale for that approach?

2 MR. PEARCE: It used to be \$100,000 limit,
3 and it moved up and I can't remember whether it was in
4 1999. I think it was '99 when we passed our
5 revisions. I think it was intended to address the
6 people who -- working families trying to get into home
7 ownership, so they're subprime borrowers.

8 So I do think it's a proxy for subprime or a
9 proxy for people who don't make a lot of money, who
10 are trying to develop home ownership opportunities.

11 MS. BRAUNSTEIN: Lori, you've got different
12 stages too, don't you, in your loans?

13 MS. SWANSON: We do, and actually years
14 ago, Minnesota banned prepayment penalties outright,
15 and then we kind of let up on those laws and allowed
16 prepayment penalties to be applied.

17 Then, in the last several years, we've seen
18 some real abuses with regard to prepayment penalties,
19 particularly in the subprime market. So this year, we
20 once again banned prepayment penalties altogether in
21 the subprime market, primarily doing the subprime
22 because that's where we were seeing the abuses.

23 Again, it was situations where people were
24 particularly in the wave of defaults and foreclosures,
25 where people had prepayment penalties and now you see

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1 that they're in trouble. They try to refinance or,
2 you know, refinance their home, but yet they have
3 these hefty prepayment penalties.

4 And we've seen -- we've taken some past
5 enforcement cases where brokers put people into very,
6 very high cost loans and didn't adequately disclose
7 the prepayment penalties, and then the borrower was
8 kind of trapped in that loan or had trouble getting
9 out of that loan, due to the prepayment penalties.

10 That's kind of a history of why we took that
11 action. I think prepayment penalties are a problem
12 area, and something that I would certainly encourage
13 the Board to look at.

14 MS. BRAUNSTEIN: How are you defining
15 subprime for those?

16 MS. SWANSON: We have a very, very, very
17 long definition of subprime.

18 (Laughter.)

19 MS. SWANSON: I don't have enough time left
20 in the hearing for me to read it to you, but it's
21 based on a percentage above the U.S. Treasury yield,
22 essentially.

23 (Simultaneous discussion.)

24 MS. BRAUNSTEIN: Kind of a --

25 MS. SWANSON: Kind of yes, it is.

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1 (Simultaneous discussion.)

2 MR. CHANIN: Is there, for the prime market
3 though, then, you don't ban them. So is it your
4 sense, either from your investigation review of this
5 or discussion with lenders, that there's a tradeoff in
6 terms of the market, i.e., that consumers who get
7 those in the prime market get a lower interest rate or
8 some other benefit, or you simply didn't see the
9 problems there?

10 MS. SWANSON: My impression, we have some
11 limitations on the ability to have prepayment
12 penalties, even in the prime market. For example,
13 even in the prime market, they're banned upon a sale
14 of a home. If you sell your home, there can't be a
15 prepayment penalty, or if you refinance after 42
16 months, there can't be a prepayment penalty.

17 So we have a number of limitations on it.
18 But my impression is that in the prime market, that
19 there have been less abuses, at least based on the
20 cases that I've been seeing. Better transparency,
21 better disclosure, and then more of a tradeoff than in
22 the subprime market, when they've tended to be put
23 into products without people even necessarily knowing
24 they're there.

25 GOVERNOR KROZNER: Let's go to -- well,

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1 please.

2 MR. DECKER: Well, I'd just make the point
3 that I think, you know, on the question of prepayment
4 penalties, as on many of the issues that we're
5 discussing today, the issue boils down at, at least on
6 some level, accessibility and cost of credit versus
7 consumer protection.

8 So you know, if you ban the prepayment
9 penalties outright, some loans simply won't get made,
10 because the lenders who make those loans need to know
11 that the loan will be on the books for at least some
12 defined period of time, or if not, then the lender
13 will receive some kind of compensation. So some loans
14 just won't get made.

15 Or they'll get made at some substantially
16 higher cost. If there's no prepayment penalty, the
17 lender's going to have to require that they get some
18 way of recouping income so the loans will get made at
19 a higher cost. So I think that's ultimately the
20 tradeoff that you have to weigh.

21 MS. BRAUNSTEIN: Tom, did you -- I'm sorry.
22 Can I just follow up on that, because Tom, did you
23 find in your experience that the costs go up for
24 lending when you ban prepayment penalties?

25 MR. MILLER: I don't think there's any

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1 comprehensive study, but the impression is that it did
2 not, or if it did, it just very much at the margin.
3 And, you know, we're not aware of any loans, any
4 people in Iowa that didn't get loans because we banned
5 prepayment penalties.

6 GOVERNOR KROZNER: Joe or Ren, do you have
7 any --

8 MS. ESSENE: Well, I would just add, and I
9 think the earlier panel, Faith and Susan Davis, a
10 couple of folks, talked about that prepayment
11 penalties are, really should be tied to a clear
12 benefit to the consumer.

13 There was a study done in 2005 by Keith
14 Ernst, where he actually investigated non-prime
15 purchase loans and prepayment penalties, and found
16 that actually the value, the benefit of prepayment
17 actually went completely to the broker and the
18 consumer actually did not benefit in a price way, from
19 the prepayment penalty.

20 So I think this really challenges some of
21 our presumptions, that the mortgage market is
22 economically efficient and really there's kind of an
23 allocational efficiency problem that exists with
24 prepayment penalties. So I think that should really
25 be the focus here, you know, in that it helps lead us

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1 to believe that it's really a predatory practice.

2 GOVERNOR KROSZNER: Joe?

3 MR. MASON: I'd like to just point out, Ms.
4 Braunstein, the way that you asked your question of
5 Tom just now, and it was the right economic way to ask
6 the question. What happened to the cost of borrowing?

7 I would argue that's what we really want to
8 provide to the consumer. We want to provide a total
9 cost of borrowing. Whether it's a prepayment fee,
10 origination fee, yield spread premium, any other weird
11 term we can think of, because that's what always
12 surprises the borrower.

13 We give the borrower an APR, and then we
14 tell them the existence of these fees, and we expect
15 them to somehow work it out. They don't have the
16 capacity to do it. So let's give it to them and tell
17 them total cost of borrowing if you stay in this home
18 for 30 years, 20 years, ten, five, three.

19 Then the prepay penalty is going to spill
20 right out. You can make those comparisons across
21 different lenders, and you're going to see it. A
22 three year time interval, and remind them, this is
23 going to bite if you refinance or move.

24 So then you're going to see that total cost
25 of borrowing different. I think that's subsumes all

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1 the possible fees that we could see on the horizon,
2 new inventions, new ways to get around it. They're
3 going to come out in this cost of borrowing.

4 MR. MILLER: But the practical world for us,
5 in the study she cited, is that you know, it's all a
6 cost to the borrower, that there's no benefit.

7 MR. MASON: In the reality, and that point's
8 something, I think, has been apparent throughout the
9 day, is that the disparity between some theory and the
10 reality of this, this market. This market functions
11 in ways that don't fit the theories. The study that
12 Ren just cited, you know, explains that completely.

13 MR. MILLER: Well, once you provide the
14 disclosure, then you need to allow room for
15 competition. What we've said this morning and on this
16 panel is there's no competition at the closing table.
17 You have one provider with a monopoly on the deal.

18 So you need to give that competition 30 days
19 ahead of time or something, to allow these offers to
20 be compared across lenders. When you go to a
21 different lender, they'll say "I can beat that
22 number."

23 GOVERNOR KROSZNER: So I want to make sure I
24 understand what you're suggesting. So that you think
25 an effective way to deal with this is not necessarily

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1 to ban the particular practice, but to try to
2 formulate a disclosure that is very straightforward,
3 that includes this, and allows for comparisons across
4 -- so it's very much standardized.

5 It allows for comparisons, but would be
6 provided much earlier in the process to the potential
7 borrower?

8 MR. MILLER: Yes, yes.

9 GOVERNOR KROSZNER: How do you feel about
10 dealing with that, at least obviously we hear a lot
11 about how we have to try to improve disclosures.

12 I think what we learned from credit cards is
13 making things easily comfortable and trying to have
14 both interest rates and fees and numbers, concrete
15 numbers that people see, not an effective rate that's
16 400 percent.

17 That's just outside the realm that people
18 normally operate in. But if they see \$75 or \$750 a
19 month extra, that seems to be something that, at least
20 the consumer testing that we've done with respect to
21 credit cards, that people can understand that much
22 more readily, and it means something to them and they
23 respond to that.

24 Do you think that would be at least
25 something that should be done, perhaps along with what

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1 Steve was suggesting, having something that we -- not
2 necessarily banning the prepayment penalties, but
3 requiring them to expire with a reasonable amount of
4 time before the reset, and improving disclosures? Is
5 that something that is feasible or reasonable, or is
6 that something that is not going to fly?

7 MR. DECKER: You know, the devil's always in
8 the details. But I think that taking the approach of
9 providing for a prepayment penalty for some reasonable
10 amount of time over the loan, giving the borrower the
11 opportunity to refinance out without a prepayment
12 penalty at some point, and generally making disclosure
13 more clear and more understandable, and providing it
14 sooner in the loan closing process, are all worthwhile
15 approaches.

16 GOVERNOR KROSZNER: In practice, is it
17 possible to do what Joe was suggesting, to have the
18 disclosure sufficiently early that people really would
19 be able to do the shopping and do the comparisons?

20 MR. MILLER: You want to write a regulation
21 requiring that?

22 GOVERNOR KROSZNER: No. I know you don't.
23 So I don't think it happens short of that. I don't
24 think what's described --

25 MR. MILLER: It's certainly possible with

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1 respect to disclosure, that we can sit, that certain
2 types of disclosures have to come earlier in the
3 process than later in the process. So I didn't want
4 to submit I was proposing that particular regulation.

5 But one of the things that we could think
6 about is changing the timing, because some of the
7 disclosures come very late in the process. I think
8 Joe was getting at the issue. That's too late for
9 competition to work, and potentially one of the
10 reasons why competition isn't working is because the
11 disclosures are coming too late.

12 As I said in my introductory comments, if
13 you don't have information, market's don't work very
14 well. So perhaps we can help the working of the
15 markets -- I don't want to say by no means would I say
16 that they work perfectly, but that may be a way to try
17 to address, at least partially, some of the issues and
18 concerns.

19 GOVERNOR KROSZNER: Ren, go ahead.

20 MS. ESSENE: Yes. We're studying behavioral
21 economics and trying to understand how consumers act.

22 I think the concern I would have with that is that
23 consumers don't necessarily act rationally and gather
24 all the information and look at all of the choices.

25 One of the things that we know is that

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1 consumers really trust a trusted advisor, right. So
2 they go out, they meet with, you know, whether their
3 realtor who recommends them to a loan officer, or to a
4 mortgage banker.

5 They sit across that table and they build a
6 bond and they trust the person across the table to
7 make a recommendation. So I think that's a major
8 dynamic that's happening in the marketplace, where
9 you're really looking for advice.

10 I think it's hard to counter that with
11 enough information. As you said, information overload
12 is incredible, and your comments, I think, get
13 directly to that point.

14 So you know, I wouldn't throw out
15 disclosures and say disclosures aren't important,
16 because absolutely information is a good thing. I
17 think the timing is a critical component of this. I
18 don't know that three to seven days before closing,
19 you know, is enough time.

20 I know that's been a recommendation that's
21 been put out there. I believe Kathy Cloy's paper
22 talks some about that. I think much earlier in the
23 process, you know, good faith estimates. Is there a
24 way for a good faith estimate to actually be, go hard
25 earlier in the process, so that folks actually have a

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1 chance to shop?

2 If we want consumers to shop and that's what
3 we want to accomplish, then boy, people should really
4 get that early on. I think a loan officer, you know,
5 it's a computer world. They know -- they have a
6 general sense of where the borrower is going to be
7 coming in.

8 I think they'd get much closer to what that
9 end loan product's going to look like a lot sooner.
10 Susan Woodward did a pretty good study, where she
11 actually asked the question "Is information enough?"
12 She found that when consumers were looking at --
13 presented with a single price, they were much more
14 likely to be able to make a better choice than when
15 there was multiple dynamics.

16 So I think again that complexity is very
17 difficult for consumers. So to think that you're
18 going to give them price points on multiple options,
19 and then have them be able to do an analysis of all
20 that data to make the best choice, again, I think
21 that's probably less likely.

22 So the more that we can make them simple,
23 some of things that I believe the Fed, that Tom
24 Jergen's work has looked at, the more we can simplify
25 that and have it early on, and the best chance we have

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1 is with disclosures.

2 GOVERNOR KROSZNER: I think that's certainly
3 something that we'd like, to make things simple,
4 comfortable, find out which number is relevant to
5 people. Sometimes people say well, an effective rate
6 of interest could be a very useful number.

7 But we found that many people just didn't
8 pay attention to it. But when they saw that it was X
9 number of dollars that month. So maybe one relevant
10 type of disclosure is the payment per month, perhaps
11 along the lines that Joe was suggesting, that we might
12 give them some alternative scenarios of if you leave
13 in two years or five years.

14 Obviously, you don't have the information
15 overload and just give every possibility. But
16 thinking along those kinds of lines, how to thread the
17 needle to get enough information out there early
18 enough that people can make choices, but not have so
19 much that it just becomes confusing and useless, and
20 it's just ignored.

21 MS. ESSENE: One thing I would just follow
22 up to that, just as a suggestion or a thought, is that
23 consumers really respond both the framing but also to
24 the incurring of a cost.

25 So if you could actually -- maybe you have

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1 kind of a simple loan that you would do a comparative
2 to, to say here's what a simple loan product would
3 look like, and we'll compare your offer to what this
4 simple loan looks like.

5 Then they could start to understand and
6 maybe ask questions, because that's how consumers --
7 they understand, they differentiate between
8 information more easily than one number in a box.

9 GOVERNOR KROSZNER: Then we have our so-
10 called CHARM booklet that has some baseline
11 comparisons that could be used. But I think we can
12 build off of that to try to make things much more
13 consistent, or have an ideal to make things much more
14 consistent.

15 So that people can actually have some sort
16 of base for let's say the CHARM booklet that they are
17 now required to have with the disclosures that they
18 get, and get that in a timely fashion, that can be
19 helpful.

20 MR. PEARCE: To follow up on something, I
21 agree with everything Ren said, so I'll say it's Tom.

22 But remember, these are folks -- assuming the
23 market's working well, in that people with subprime
24 credit are getting subprime loans. So take out the
25 folks that get in the wrong bucket.

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1 If you have subprime -- these are folks who
2 have had trouble managing their finances, and trouble
3 identifying the right credit choices for any number of
4 reasons. And to think that a disclosure, even an
5 early disclosure that's totally clear, that's got one
6 comparison to a simple loan, is going to prevent a bad
7 loan or a bad choice, is -- it's just not -- it's
8 going to work for some, but not others.

9 If you want to change the marketplace,
10 banning prepayment penalties in subprime loans does
11 that, because you won't have lenders who will pay
12 brokers higher yield spread premiums, because they'll
13 know they won't get it back, because the borrower
14 might find out that they got overcharged.

15 They'll go down the street and get a better
16 loan. I mean isn't that what we want in a competitive
17 market, that lenders will compete and if they give
18 someone a really bad loan, "Hey, I can go down the
19 street. I can get a better loan tomorrow."

20 GOVERNOR KROSZNER: I think that's exactly
21 right, and that's what we want to do. How do we make
22 the markets work most effectively, and effective
23 markets work to weed out abuses. Not completely for
24 sure, but when markets don't work effectively, then
25 people don't get the products that are best for them,

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1 because they don't know how to choose them. They
2 don't give the right signals to the market.

3 But I see that we're now getting close to
4 the end. I'm giving a little bit of short shrift to
5 the escrow issues, but since they had little bit of
6 extra shrift in the earlier discussion, I think that
7 should be Okay.

8 So I want to turn to some of the escrow
9 issues, and if you want, we can take the same type of
10 approach of looking at some of the ways in which
11 they've been regulated in the individual states and
12 share some of those experiences, and think about how
13 we can build on those or if there are alternatives
14 that may be more appropriate. Lori, you might want to
15 start?

16 MS. SWANSON: Yes, sure. Well, just seeing
17 abuses essentially with mortgage products being
18 marketed on the monthly payment amount, nobody really
19 looking at much else other than how much am I going to
20 have to pay per month, and we've also seen a lack of
21 disclosure of things like taxes and insurance, where
22 particularly a first time borrower, for example, who
23 hasn't had a mortgage before, doesn't understand and
24 appreciate that they have to pay other expenses like
25 taxes and insurance.

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1 How we dealt with it in the Minnesota
2 legislation is the first time, and then each time
3 thereafter, the broker orally informs the prospective
4 borrower what the monthly payment amount is going to
5 be, how much they owe on the mortgage, that the broker
6 has to, at the same time, orally inform the borrower
7 that these other amounts are due for taxes and
8 insurance.

9 I'd just echo the last comments. When
10 you're dealing with disclosures, it does get to be
11 very, very tricky. All of us here at this table may
12 read disclosures, but a lot of people we're trying to
13 protect are not the people at this table. So it is a
14 tough issue.

15 The attorney generals frequently take
16 enforcement actions where, including the mortgage
17 area, where people have disclosed all kinds of things
18 in writing, but what happens is the broker basically
19 lies orally.

20 That's what the borrower really relies on.
21 What is the broker orally telling the borrower?
22 That's how we've dealt with it on the tax insurance
23 issue in the Minnesota bill.

24 MR. ANTONAKES: We've seen, you know, abuse
25 in the refinancing, primarily where a comparison is

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1 made to a loan that includes taxes, insurance, to a
2 new loan that wouldn't, and therefore they provide
3 evidence there will be a smaller payment.

4 We would recommend the Board consider the
5 requirement that taxes and insurance be included, with
6 the opportunity for the consumer to affirmatively opt-
7 out of having their taxes and insurance included.

8 MR. MILLER: We've seen the same issue, the
9 same problems with brokers, the ones that, you know,
10 try and take advantage of anything and everything, all
11 too many of them, at least in the past.

12 In terms of, you know, what you were
13 articulating before, transparency and being able to
14 make a meaningful comparison, having everybody in the
15 subprime area do the escrowing seems to make a lot of
16 sense.

17 MR. PEARCE: I'd agree with Tom. I think
18 apples to apples. If you're marketing loan products
19 and I can take off a portion of the cost and sell you
20 on that and convince you of that, and not include
21 those costs, that's hard to have a competitive offer.

22 I would also think a little bit about the
23 prime market versus the subprime market. I mean I
24 think the notion of not having escrows, in the prime
25 markets people might have better use of their money,

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1 might put it in different places, and they know they
2 will have \$2,000 to pay the tax bill when it comes
3 due.

4 I think I have a lot less confidence in the
5 subprime market. People are actually thinking, oh, if
6 I invest my money here, I'll get a higher return and
7 the lender won't be holding it or the servicer won't
8 be holding it. I don't think folks are making that
9 calculation. So another reason to include taxes in
10 escrow.

11 GOVERNOR KROSZNER: What's your thoughts on
12 the escrow issue?

13 MR. DECKER: I don't feel so strongly about
14 the question of whether there should be, you know,
15 sort of a leaning towards including taxes and
16 insurance or not including taxes and insurance in
17 escrow payments.

18 But I would argue that, like the gentleman
19 from Massachusetts just said, ultimately the borrower
20 should be able to opt out and it should be, you know,
21 a decision between the borrower and the lender as to
22 what's the best course for that particular borrowing
23 situation.

24 Some borrowers like the idea of being able
25 to pay their taxes and insurance every month, and not

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1 have to worry about a bill when it comes. Even prime
2 borrowers, you know. It's a convenience. From the
3 servicer's perspective, it actually makes the
4 servicing more valuable, knowing that there's an
5 escrow to pay those bills when they come due.

6 But some borrowers feel that, like the point
7 that was just made, they've got better uses of their
8 money.

9 MR. ANTONAKES: Mike and I have agreed on
10 something.

11 GOVERNOR KROSZNER: I think we have a lot of
12 agreement on escrows. Do you guys have any systematic
13 evidence on the role of escrows?

14 MS. ESSENE: Well, I think the more
15 systematic evidence around the role of default
16 options. So that's one of the kind of best
17 behavioralist principles. So you can see that with
18 401(k)s and the uptake of 401(k)s, and that if you
19 promote the good option, more people are going to
20 uptake it.

21 For example, someone with a 401(k), if you
22 say when you come into a company, you're automatically
23 enrolled, and if you want to opt out you can. The
24 uptake rate is the difference 80 percent and 30
25 percent, or something right around there.

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1 So it's a substantial difference. What we
2 know is that it's not necessarily a consumer choice.
3 So I think having the default be to the -- for the
4 social good, you know, for folks to be able to make
5 their payments, that's the right thing to do, and then
6 allowing an opt-out principle.

7 GOVERNOR KROSZNER: Joe?

8 MR. MASON: Yes, but I want to follow up.
9 The key to that too is that you're just enrolled. You
10 don't get an opt-out check often when you start the
11 job, but then you have to file form later, which you
12 often don't get around to doing. That's how that
13 works, and that's how PMI works, cancelling PMI on the
14 other side, because many people never file that form
15 to cancel PMI.

16 I do believe in at least disclosing escrows,
17 because it's a matter -- or at least disclosing
18 insurance and tax information. It's something that I
19 think most subprime borrowers don't think about,
20 knowing that they have to make the tax payment or they
21 lose the property.

22 But I would in fact go another step on this,
23 because I think this is where, as Tom mentioned, is
24 where a lot of lenders leave off. They beat on
25 payments because they leave off tax and insurance.

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1 But they're also winning a lot of business
2 from FHA, because they leave off the FHA mortgage
3 insurance premium as well, but they replace that with
4 credit life and disability life.

5 So I think to require them to report all
6 monthly payments associated with that loan, so have
7 tax, insurance and then any associated -- any other
8 fees left with that. So you get a real apples to
9 apples comparison on the payment.

10 I think you'll see more FHA loans. Really,
11 I would argue, going where they should.

12 GOVERNOR KROSZNER: Do you guys have
13 anything on this issue? Any questions? Any last
14 comments that people would like to make, on any of the
15 issues? Not just escrow, but the whole thing that
16 we've discussed?

17 MR. MILLER: Well Mark has swung me around
18 on the prepayment issue.

19 (Laughter; simultaneous discussion.)

20 MR. MILLER: It went from a small priority
21 to a big priority. I was always on his side, and what
22 did it is the huge use of the brokers to manipulate it
23 to their advantage, and the study that Ren cited to
24 bear that out.

25 Finally, Governor, I'd like to thank you and

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1 the staff for conducting these hearings, and all the
2 work that you're putting into it. Obviously, you're
3 very focused, you're very serious about this and we
4 appreciate that.

5 GOVERNOR KROSZNER: Any other comments? We
6 do take this very, very seriously, and this is why
7 we're so pleased to have so many of you in the
8 audience, to have so many excellent panelists who are
9 willing to come, taking their time, because we don't
10 munificently remunerate people to come on these
11 panels.

12 They pay their own way to get here and so we
13 are very, very pleased to have such excellent
14 panelists, to have had such robust discussions, this
15 afternoon as well as this morning.

16 As I've mentioned, we will be open for
17 comments, formal comments until August 15th, and we
18 look forward to any written comments you may have.
19 Any of the panelists, if they want to supplement what
20 they've said, anyone from the audience and anyone in
21 the public can submit that.

22 As I also said, we're going to have an open
23 mike set of presentations from people who have signed
24 up, and what we will do, since we've been going for
25 about two hours, let's take a very short break and

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1 start at ten minutes after 3:00.

2 We'll have the open mike presentations,
3 where people will have three minutes -- who were not
4 up front in the panels, to make an oral presentation,
5 and then of course they can submit any further written
6 testimony they would want.

7 Thank you very much. I really appreciate
8 your coming here.

9 (Whereupon, a short recess was taken.)

10 GOVERNOR KROSZNER: Great. Let's try to get
11 started again. Those of you who have signed up to
12 speak, if you could move over to here? We have
13 reserve seats for you.

14 We have the order that you're in, and if you
15 could sit in those seats, it would be very helpful, to
16 make sure to be able to move as expeditiously as
17 possible, because I want to use -- make sure that we
18 have the time for people to be able to speak.

19 I want to apologize in advance for having
20 this very strict time limit. I know that many of the
21 people who are going to be speaking have faced some
22 personal tragedies for their families, for friends and
23 loved ones.

24 We do take this very, very seriously. But
25 just to make sure to be able to get everyone -- make

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1 sure that everyone does have a chance to have an
2 opportunity, we will have to enforce the three minute
3 limit.

4 But of course, you'll be able to submit a
5 statement of any length you wish for the record. You
6 just have to do that by the 15th. So let's begin, and
7 we're going to begin first with Judith Kennedy. Thank
8 you very much. Our timekeeper is just right.

9 MS. KENNEDY: Thanks for doing this. I am
10 CEO of National Association of Affordable Housing
11 Lenders, 50 of the largest banks and 50 of the blue
12 chip non-profit lenders, who are America's leaders in
13 lending and investing in underserved areas.

14 I appreciate the opportunity to talk about
15 how we see the problem, teeing off where you were, the
16 last panel. We're concerned about how to make markets
17 work effectively, and we're concerned about borrowers
18 walking away from legitimate consumer-friendly loans,
19 down the street to the predatory lender.

20 We are in this pickle, we believe, because
21 we have a very un-level playing field, a two-tiered
22 mortgage market in our country, one involving insured,
23 examined institutions and the second involving
24 government-sponsored enterprises, fair practices and
25 unregulated, unexamined lenders.

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1 Essentially, the secondary market is a town
2 with no sheriff. For years, insured institutions have
3 been telling Fannie Mae and Freddie Mac that their
4 fear of buying legitimate low down payment loans, that
5 banks have known for 10 to 20 years are safe and
6 sound, often involving neighborhood housing services,
7 soft seconds and on and on and on.

8 But that fear of buying was causing them to
9 lose customers to the subprime lender down the street,
10 who could assure them that they could have 40 percent
11 of their income paid, the lowest monthly payment, no
12 escrows, etcetera, etcetera.

13 Still today Fannie Mae and Freddie Mac do
14 not buy legitimate CRA mortgages, single family or
15 multi-family. So as they resisted buying these
16 legitimate loans, and just to put it in perspective,
17 \$316 billion worth of CRA single family loans in 2005
18 alone.

19 What we didn't understand was what the
20 bankers were saying, and that is that the Fannie Mae
21 and Freddie Mac involvement with the subprime market
22 was as, what the LA Times call, the chief enabler.
23 They were the primary financiers of mortgage-backed
24 securities backed by subprime loans.

25 So in addition to there being no legitimate

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1 secondary market, certainly no government-sponsored
2 benefits for CRA loans, we had the GSEs we now know
3 buying 44 percent of all subprime MBS in 2004, 37
4 percent in '05, and only 25 percent the first half of
5 '06.

6 This means that at the same time they were
7 ignoring 300 billion of CRA mortgages, they were
8 financing 174 billion of subprime. All with -- well,
9 not all. We don't know what's behind them. But many
10 with terms that they publicly issued and insured
11 institutions couldn't originate.

12 You've got to level the playing field. The
13 GSE reform bill or something like it has to cause the
14 secondary market to have a sheriff. The GSEs have to
15 be persuaded or told to buy legitimate consumer-
16 friendly CRA loans.

17 You need to revisit existing filters that
18 failed. How did HUD allow the GSEs to take those
19 subprime MBS and have them use them for their
20 affordable housing goals? How did the secondary
21 mortgage market enhancement and the rating agencies
22 that are working?

23 So these are some of the things that I think
24 we need to build on.

25 GOVERNOR KROSZNER: Thank you very much.

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1 The next speaker is Samuel Bornstein.

2 DR. BORNSTEIN: Thank you for giving me the
3 opportunity. My name is Samuel Bornstein. I'm a
4 professor at Kean University. I'm a professor of
5 Accounting Taxation. I've been there for 30 years.
6 Parallel with that, I'm a CPA and consultant for the
7 same 30 years.

8 I viewed this from an interesting
9 perspective. I also have just recently completed five
10 years of research of small business failure, that has
11 evolved into a discussion now of subprime, because
12 they have something in common.

13 The solution to small business failure and
14 subprime, the same common solution is financial
15 literacy. So basically -- by the way, this is a
16 supplemental to my original comment made on June 3rd,
17 which is on the website.

18 The topic of this comment is "Financial
19 Literacy Implications: My Suggested Solution to the
20 Subprime Mortgage Lending Interaction Between Borrower
21 and Lender." The sub-topic is "Let's not react to an
22 accident; let's prevent one."

23 Financial literacy will enhance an
24 understanding that is necessary to make an informed
25 mortgage loan decision. This applies to all

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1 consumers, especially to the low and moderate income
2 borrower.

3 Any solution to subprime mortgage lending,
4 delinquency, foreclosure phenomena should also address
5 the need for a clear understanding of the various
6 aspects of the subprime mortgage, especially on the
7 part of the borrower and lender.

8 Basically, I believe we need to explore
9 technical tools to help us. Financial literacy
10 involves education and learning. The results of
11 recent research conducted at Johns Hopkins University
12 could change the way we think of education and
13 learning.

14 The conclusion was that we learn more by
15 inference rather than by direct instruction. The
16 learning process is better accomplished when the
17 student figures it out himself, rather than by being
18 told what to do.

19 As an educator for the past 30 years, I've
20 learned that the student is the student's best
21 teacher. As a practicing CPA and consultant for the
22 past 30 years, I also realized that the educated
23 client is also the best client.

24 This concept can be applied effectively to
25 the borrower-lender interaction in the mortgage loan

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1 decision. In my comment submittal on June 3rd, I
2 referred to a need for a technological tool that can
3 help both the borrower and lender understand the
4 implications of lending decisions.

5 The key factor is to concentrate on the
6 borrower's ability to repay the obligation. We need
7 new and innovative technological tools. The ideal
8 tool would be able to accept input of financial data
9 and changes, unique and specific to each individual
10 borrower situation.

11 This would include income, expenses, assets,
12 liabilities, including the various items of principal,
13 interest and insurance, as well as liabilities which
14 include debt, such as credit cards and auto loans.

15 In fact, the technological tool would view
16 the borrower as a business, in order to determine the
17 borrower's capability to handle the mortgage loan.
18 There are presently software programs that use
19 analytics to accomplish this for businesses.

20 However, this is now missing.
21 Unfortunately, what's missing is the missing
22 ingredient of the interpretation of the results in a
23 language that everyone can understand.

24 The technological tool should be in English
25 or in Latino, as to maintain simple and clear language

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1 which the borrower can understand, and accompanied by
2 graphics. This report will help the borrower
3 understand the implications of the loan decision.

4 The borrower can then retain this narrative
5 and bring it over to his counselor for discussion and
6 thought. Thank you.

7 GOVERNOR KROSZNER: I'm going to turn to
8 Bill Garber.

9 MR. GARBER: Thank you, Governor. I
10 appreciate the opportunity. I'm Bill Garber with the
11 Appraisal Institute, which is the largest association
12 of real estate appraisers in the United States.

13 I'd like to encourage the Fed to focus on
14 issues relating to real estate appraisals,
15 particularly the importance of an independent real
16 estate appraisal process.

17 Sound real estate lending is based on three
18 C's -- credit, capacity to repay, and collateral.
19 Collateral is where the appraisals come in, so they
20 serve a very important role in real estate lending,
21 and we feel they serve a role in consumer protection.

22 It's true that a good appraisal, an honest
23 appraisal is a lender's best friend, because it helps
24 mitigate losses; it helps ensure that lenders do not
25 overextend credit.

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1 They also serve consumers, in a few ways.
2 One is in the sense that consumers oftentimes pay for
3 appraisals. So they deserve to have an honest
4 appraisal, and they definitely deserve not to be
5 steered into a home or have a mortgage that's worth
6 \$300,000 or is costing them \$300,000, where the house
7 is only worth \$200,000.

8 Also, the existing federal rules require
9 appraisals to be disclosed to consumers within 30
10 written days, or 30 days upon written notice. Also,
11 many times, when the appraisal comes back, it allows
12 for buyers and sellers to renegotiate prices within
13 the terms of the contract.

14 So in this sense, we think that appraisals
15 serve both lenders and borrowers.

16 In 1989, Congress passed FIRREA, which
17 required licensing for real estate appraisers, and it
18 set forth a whole series of events by the federal bank
19 regulators, including implementation of regulations
20 and guidelines, some of which prohibit borrowers from
21 ordering appraisals. They require the use of
22 licensed, certified appraisers in conformance with
23 uniform appraisal standards.

24 Over the last few years, the federal bank
25 regulators, when conducting bank examinations, have

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1 found widespread breakdowns in appraisal independence
2 within examined institutions. They found that there
3 are individuals within the institutions that are
4 controlling the appraisal process, and then also have
5 the ability to sign off on a final loan decision.

6 There's a great deal of instances where
7 pressure, intimidation, coercion is applied on an
8 appraiser, because the appraisal is seen as an
9 obstacle in the financing process. Now the bank
10 regulators have issued restatements on their
11 requirements in 2004 and 2005.

12 Unfortunately, what we see, if the federal
13 bank regulators have the opportunity to examine non-
14 bank mortgage lenders and mortgage brokers, we would
15 see that this nuance between those with a vested
16 interest in the transaction and those controlling the
17 appraisal process, we find that to be the norm, rather
18 than the exception.

19 Too often appraisers are pressured and
20 intimidated to artificially inflate appraisals. We've
21 seen these cases come forward. The AmeriQuest
22 settlement recently involved inflated appraisals and
23 breakdowns in appraisal independence.

24 We're also seeing, as a result of a lack of
25 rules in this unregulated area, new rules coming out

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1 from the states, prohibited practices, requirements
2 for mortgage brokers and mortgage lenders to not
3 pressure appraisers, and criminal penalties against
4 coercion and intimidation of appraisers.

5 So I would just like to encourage the Fed to
6 include in these discussions about abusive and
7 deceptive practices, the idea that an inflated
8 appraisal or intimidating an appraiser could be
9 included under these definitions. We would be happy
10 to assist in those efforts.

11 GOVERNOR KROSZNER: Thank you very much.
12 Lisa Rice.

13 MS. RICE: Good afternoon. Thank you,
14 Governor. My name is Lisa Rice. I'm with the
15 National Fair Housing Alliance. I have three points
16 to make.

17 The first is that the APR is not a useful
18 tool in this marketplace, and hasn't been for some
19 time. This is largely because terms and conditions
20 can be changed at the closing table in many
21 environments.

22 We informally have polled title companies in
23 Ohio, and ask them in what percentage of the cases did
24 they see terms and conditions changing at the closing
25 table. The responses ranged between 50 percent of the

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1 time and 65 percent of the time.

2 Now when I was a member of the CAC, I can't
3 count the number of times that I heard people talk
4 about educating consumers on the effective use of the
5 APR as a shopping tool. The sad reality is that
6 people cannot do that in today's environment.

7 In addition to that, even if people do use
8 the APR as a shopping tool, there's not an apples to
9 apples comparison, because the underlying features and
10 components of the loan obviously may not be the same.

11 The second point is that consumers are often
12 encouraged, even when it's loan terms and conditions,
13 to change at the closing table. They're encouraged to
14 go ahead and to close on that loan, because if they
15 pay their bills on time, they can refinance in a
16 couple of years into a better loan.

17 For the customers that we see coming into
18 our offices across the United States, this is not the
19 case. One of the reasons obviously is because
20 consumers end up upside down in their loans. The
21 second reason is because their credit score actually
22 has not improved to enable them to get into a better
23 product.

24 I think one of the things that a lot of
25 people don't talk about or maybe don't realize is that

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1 the credit score is not simply a function of whether
2 or not you pay your bills on time. Available credit
3 is a major component in many credit scoring
4 algorithms.

5 Especially if you're refinancing, if you're
6 refinancing the difference between your credit high
7 balances, your total credit high balances and your
8 total utilized balances, will be very low, resulting
9 ultimately in a lower credit score.

10 The third point is that when you drill down
11 and peel back the layers, what we're really dealing
12 with are systematic fair lending issues and abuses.
13 I'd like to see the Fed hold hearings, comprehensive
14 hearings, on fair lending enforcement and compliance.

15 The Fed and other regulators have to be more
16 diligent about fair lending compliance for banks and
17 bank holding affiliates. Included in that discussion
18 should be specific questions about fees, and which
19 fees are to be included in the HOEPA calculation.

20 Also included in that discussion needs to be
21 a discussion about credit scoring algorithms and
22 models, because one of the things that we're finding
23 out from rating companies is that the credit score may
24 not be the best determinant for determining the rate
25 for a pool of loans. However, we're not seeing that

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1 correlating into the pricing scheme. Thank you.

2 GOVERNOR KROSZNER: Thank you very much.
3 Now we will hear from Paula Rush.

4 MS. RUSH: Hi. I guess I'm the first
5 consumer here. I'm a consumer victim turned advocate.
6 I've been helping people all over the country, to
7 hopefully avoid the experience that I had.

8 I did not consider myself a subprime
9 borrower. My credit score was above 620.
10 Nonetheless, I fell victim to a lender and a broker
11 who totally misrepresented a loan to me. It was a pay
12 option ARM loan, which you haven't talked much about
13 here today.

14 But I'm here to tell you that this loan is a
15 HOEPA loan on steroids. This loan is the most
16 damaging loan out there in this market. If it made
17 any sense at all in a market that was appreciating, it
18 certainly makes no sense at all in a market when real
19 estate is depreciating.

20 This product has become a product that
21 lenders are selling as an affordability tool to
22 consumers, who are having trouble with adjustable ARMs
23 adjusting up. The problem is it's only going to be a
24 temporary fix, where payments will temporarily be
25 lowered, but will increase very rapidly, and massive

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1 amounts of negative amortization is taking place.

2 So you're going to have a group of consumers
3 who are going to owe much more on their houses than
4 they're worth when these resets happen. So if you
5 think you have problems now, if you continue to let
6 these loans proliferate, which they are, you're going
7 to have extreme problems in foreclosures going forward
8 when these loans reset.

9 These loans also create phantom profits for
10 the lenders. When they're booking profits on their
11 books, saying that they're getting full payments on
12 these loans, when in fact 70 percent are only making
13 minimum payments.

14 So what is going to happen to the mortgage-
15 backed securities on Wall Street when these bills
16 become due and these people are not going to be able
17 to pay these loans? The underlying collateral is not
18 going to be worth what is owed on these loans.

19 I have to say that today you talked about
20 quite a few things. One is prepayment penalties. I
21 do think this is trap that lenders use to trap people
22 into bad loans. I was trapped into my loan by an
23 expensive prepayment penalty, and I dispute the
24 industry saying that these prepayment penalties are a
25 tool that they need to ensure that they have the loan

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1 for a certain amount of time.

2 I have a rate sheet with me today, that says
3 that the broker gets a kickback based on that
4 prepayment penalty. My broker made \$19,794 on a YSP
5 for putting me in this loan. Part of that was a one
6 percent fee that he got for giving me a prepayment
7 penalty.

8 So these lenders are giving the brokers the
9 money up front. That makes no sense for them to say
10 that they need that money on the back end in case the
11 person gets out of the loan. Stop giving it to the
12 broker. Does any broker -- do you make \$19,794 a day
13 or two days for doing a loan? I don't think so.

14 This is the kind of fees these brokers are
15 making, and they're making it under the table, on the
16 back end, in the form of YSPs that the borrower
17 doesn't even know that they're getting these funds.

18 I have the rate sheets. They're based on a
19 lot of other things. I have lots of things to add to
20 this discussion. I know we have limited time, so I
21 won't be able to finish. I'll submit all of my
22 comments in writing.

23 GOVERNOR KROSZNER: Thank you very much. I
24 appreciate that. We're now going to hear from Sylvia
25 Lake.

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1 MS. LAKE: Good afternoon Governor, and
2 thank you for this opportunity to speak. My name is
3 Sylvia Lake. I'm with the National Community
4 Reinvestment Coalition, and NCRC operates a CRF, a
5 community rescue fund, and we have for many years.

6 We see borrowers every day or very
7 regularly, who are on the verge of bankruptcy and
8 foreclosure due to abusive lending practices. We
9 either mediate with the lenders to modify the loans
10 and terms, or arrange a rescue refinance with our loan
11 partner, which is HSBC.

12 Most of the loans in the CRF program are
13 subprime and non-traditional ARMs or stated income
14 loans. Due to our experience with the CRF program, we
15 would agree with Congressional testimony, which was
16 offered by Sheila Bair from the FDIC, that in many
17 cases these borrowers, borrowers for exotic loans,
18 would have qualified for less expensive and safer
19 fixed rate loans.

20 So the devastation this is causing with the
21 predatory lending is really frustrating, because
22 especially knowing that federal regulation and
23 legislation here could have avoided much of the
24 abusive lending practices responsible here in the
25 prime and subprime markets.

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1 NCRC believes very -- in strong limits and
2 prohibitions that could be applied to non-traditional
3 and high cost loans, in order to prevent unfair and
4 deceptive practices, which violate HOEPA.

5 Prepayment penalties. NCRC believes that
6 the Federal Reserve must apply strict limits to
7 prepayment penalties. Prepayment penalties must not
8 apply after the expiration of the teaser rate in ARM
9 and subprime loans.

10 We feel strongly that escrows for taxes and
11 insurance should certainly be included in every loan,
12 both prime and subprime, fixed and adjustable rate,
13 and stated and low doc loans, we agree with the
14 Comptroller of the Treasury that stated and low doc
15 income loans are prone to abuse by predatory lenders
16 and brokers inflating borrowers' incomes. This type
17 of abuse should not be allowed.

18 I'm just going to take a moment to speak
19 from personal experience as a borrower, because I
20 think when we speak of consumers in the abstract, it's
21 easy to distance ourselves from a problem that's very
22 real.

23 The borrower here is quite vulnerable to the
24 recommendation of the broker. As a first time
25 borrower, there's one set of circumstances. You are

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1 clearly reliant on brokers' advisement. I got into a
2 piggyback loan. Fortunately, all it did was save me
3 PMI. But if I had been offered an ARM or hybrid loan,
4 it would have seemed like the best option. It would
5 have seemed like the opportunity for me to get into a
6 home at that time.

7 So I would just encourage you to use your
8 capacities here to enforce stricter regulation. Thank
9 you.

10 GOVERNOR KROSZNER: Thank you very much.
11 We're now going to hear from Michael Nelson.

12 MR. NELSON: I'm Michael Nelson and I run
13 the credit ratings business for the U.S. mortgage-
14 backed securities for Dominion Rating Service, which
15 is one of the credit rating agencies.

16 My background is a little unique, because in
17 addition to working for the rating agencies for many
18 years, I worked as an investment banker, creating
19 mortgage-backed securities and actually worked for the
20 largest subprime lender at that time in the country
21 for many years. So I have an interesting background.

22 Just briefly in terms of S&E liability,
23 which is the capital markets issue relating to
24 liability on some of these laws, HOEPA's been pretty
25 effective in that regard, in terms of creating a limit

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1 on the secondary markets and what they could do.

2 The concern with S&E liability, and Michael
3 mentioned it; it was actually an interesting paper
4 here for the American Securitization Forum, is that
5 when it's not exact and when it's not limited, the
6 capital markets shut down. We've heard stories about
7 New Jersey and Georgia and some of those instances.

8 So what we would urge regulators, and we
9 talk with them regularly, is that while it's certainly
10 important that the capital markets be aware that they
11 are funding all of these loans, that if it's not
12 precise and exact and limiting in nature as to what
13 the liability is, the market will tend to shut down.

14 In that case, essentially they'll be no
15 funding for those assets whatsoever. From the lender
16 side, having worked at a lender, lenders do find ways
17 to make loans if the market wants it. That doesn't
18 mean then in some cases they don't make mistakes, and
19 clearly we hear about many of those.

20 But if there's not an opportunity for credit
21 out there, or a need for credit, it wouldn't in fact
22 occur. I think that's something to be aware of. Many
23 of these lenders, the large ones, do buy from the
24 brokers that you have been hearing about, and I think
25 it's important to police the brokers, because in many

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1 cases that's where many of the loans are coming from.

2 From our experience in dealing with some of
3 these predatory lending laws, we've determined that
4 there is a patchwork of existing, both civil and
5 criminal penalties which are out there, which do cover
6 a variety of items such as a fraud and mortgage fraud,
7 etcetera. In many cases, I believe that these items
8 can fall under those statutes.

9 Somebody mentioned before about the Fed, and
10 I think there was a remark about whether they have
11 limited powers or not. Whether they have limited
12 powers or not, having the Fed as the centerpiece, in
13 terms of all the other regulators, even as a
14 figurehead, will make an enormous difference in my
15 opinion.

16 In terms of the specific items that were
17 asked about, I think in some circumstances they're
18 Okay and some are not. But just to talk about the
19 prior speaker's comments, I took a mortgage out
20 recently and I'm fairly comfortable with the
21 documentation.

22 I didn't see any disclosure in there that
23 said if you don't make your payment, your house could
24 be taken away. If you have an adjustable mortgage, it
25 could go up 50 percent in X amount of time. I looked

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1 for that in my mortgage.

2 We need much better disclosure, and we need
3 it in simple language, just like the SEC takes
4 prospectuses and has it in simple English. We need a
5 piece of paper that says "If we're offering you a
6 prepayment penalty, you should ask for a benefit."

7 I think if we do those things and we educate
8 folks, as one of the other speakers said, they will
9 realize that they have options that they never thought
10 they had. So thank you.

11 GOVERNOR KROSZNER: Thank you very much.
12 We're now going to hear from the Reverend Gloria
13 Sweringa.

14 REV SWERINGA: Good afternoon. My name is
15 Reverend Gloria Sweringa. I am a victimized consumer
16 of predatory lending. I'm also chair of Maryland
17 ACORN, Prince George's County ACORN, and head of
18 Maryland's anti-predatory lending efforts.

19 I really appreciate this opportunity to
20 speak to all of you, but the problem is this. All of
21 this, you know, this is a rhetorician's dream.
22 Tweaking, tantalizing, changing things just a bit,
23 simplifying. You've already let the fox into the
24 henhouse.

25 The serpents of predatory lending are

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1 sucking the blood and squeezing to death America's
2 homeowners in record numbers. How do you make the
3 market behave better? Take the blindfold off Lady
4 Justice, look the criminal element squarely in the
5 eye, and draw a line that's bright enough for this
6 blind lady to benefit from, that says "Enough. No
7 more. This far and no farther."

8 You can either decide to really protect the
9 homeowner or continue to abet the enemy, aid and abet
10 and give comfort to the enemy. Let me tell you
11 something a little bit about my story.

12 I paid off a bankruptcy in four months back
13 in '04 that I had to file, because my bottom feeder of
14 a predatory lender was calling in a forbearance that
15 was only in place because of my deadbeat deserting
16 husband's economically challenged approach to
17 financial responsibility.

18 I filed a protective 13, paid -- a bunch of
19 my relatives were obliging enough to die and leave me
20 some assets that I used to pay it off in four months.

21 In September of '05, I went home to a death, came
22 back and everybody's knocking on my door with every
23 scam imaginable.

24 I wouldn't have known that were it not for
25 ACORN's training. Thank you, ACORN. I said to one

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1 young man "Why the heck am I getting all this
2 attention?" "Reverend, don't you know? Your mortgage
3 company has a sell by date on your house." I had not
4 missed a payment. I had not been notified that they
5 had sent me into foreclosure.

6 I did not find out until I hired competent
7 representation, went to court, disputed the claim.
8 They had not only sent me into foreclosure, not once
9 but twice. It seems to me that Americans with
10 Disabilities Act, Title 2, Section on Communication,
11 entitles me to access to what goes on in my mortgage
12 banking situation.

13 Even though that bankruptcy judge warned my
14 predatory lender when I prevailed, I just found out
15 the other day the bankruptcy is still in place.

16 Now when the predators have that little
17 respect for all of you people, you're going to have to
18 get around to regulating. Thank you.

19 GOVERNOR KROSZNER: Thank you very much.
20 We're now going to hear from Gilma Merkert.

21 MS. MERKERT: Good afternoon. My name is
22 Gilma Merkert, and I'm a homeowner. Okay, thank you.

23 My name is Gilma Merkert, and I am a homeowner and I
24 live in Pennsylvania. I'd like to take this
25 opportunity to thank you for allowing me to be here,

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1 and the reason I'm here is because I am a victim of
2 the predatory lending.

3 I am also an ACORN member from Pennsylvania.

4 In the name of all the owners that we're here in the
5 same predicament all over the country, kindly I'd like
6 to request from the federal government or whoever is
7 necessary, to take care of this problem, to stop
8 immediately this abusing way of business, if it's
9 possible.

10 Personally, I'd like to keep my home for my
11 son and my family. I don't want to lose it. I put
12 much sacrifice into it, and I'm here not only to
13 request in my name but in the name of many other
14 people in the same predicament, because this is quite
15 like a nightmare.

16 I haven't been able to sleep really good
17 because I said it's going to be my son's home, my home
18 and we cannot afford to lose it. Only if we can just
19 take the right measurement at the right time,
20 hopefully things could be better for all the families
21 in this country, I guess.

22 My son is in the Army, and he's serving the
23 country. Certainly, when he comes home, I'd like to
24 have him in a nice, decent home one day. Previously,
25 I have a loan; it was variable, and it did change

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1 after three years when they told me.

2 So I went to the same broker, and I
3 requested to give me a similar product or something
4 better. What happened is he gave me a total different
5 part. He gave me an ARM, adjustable loan, and I
6 thought it would change in five years, as he told me.

7 It didn't. It changed immediately the next
8 month, the following month after I took the mortgage.

9 I call him immediately when I saw the options or
10 whatever. I never had any idea about these options,
11 and I was disgusted, because it was a nightmare right
12 from the beginning. Thank you.

13 GOVERNOR KROSZNER: Thank you very much.
14 Next is Cheryl Harvey.

15 MS. HARVEY: Hello. I'm Cheryl Harvey. I'm
16 from Philadelphia and I'm a member of ACORN. I'm the
17 mother of six and I'm a widow, and I want to say that
18 not just for myself, because I was a victim of
19 predatory lending, but it's affecting the entire
20 neighborhood.

21 People who had homes who were raising their
22 children are now in shelters. These same people are
23 now homeless, and they need somebody to step in to
24 help them, because if you don't help them now, what's
25 going to end up happening is it's going to create a

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1 catastrophe in the future, not just for them but for
2 their children, for their grandchildren.

3 As Gilma says, she wants to have a place
4 there for her son, for his family one day. I'm asking
5 you not to just look at it as a case of where people
6 are coming here and you can't see what's happening to
7 them, because it hasn't happened to you.

8 I want you to feel it as we feel it. I want
9 you to know that we are feeling it in our
10 neighborhoods, and it's happening all over the
11 country. The news is talking about how many
12 foreclosures there are. This month, 116,000 or
13 something to that effect.

14 People are hurting all over. So you're
15 going to have to do something. The government is
16 going to have to step in, because this predatory
17 lending has went too far, and there are people who
18 aren't making enough money.

19 They just raised what was the small amount
20 of money to seven dollars, and the people can hardly
21 afford to pay their bills as it is. Now with this,
22 they borrow money they can ill afford to pay back.
23 Their mortgages are going up, they're losing these
24 homes.

25 They're not going to make a choice of paying

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1 for a loan as in preference of having food on the
2 table, and I don't think anybody expects them to. So
3 something has to change. I can only pray that all of
4 you who are listening here today won't say "Well,
5 Okay. That won't work. We won't do it this way.
6 We'll go through a whole lot of rigmarole."

7 I would say all of you come together in
8 agreement and make this change. Make it today. Thank
9 you.

10 GOVERNOR KROSZNER: Thank you very much.
11 Finally, we'll hear from Allen Fishbein.

12 MR. FISHBEIN: Thank you, Governor. I'll
13 quickly sum up the day in three minutes, if I can try
14 to do that. I'm Allen Fishbein, Director of Housing
15 and Credit Policy with the Consumer Federation of
16 America.

17 CFA is a federation of some 300 consumer
18 organizations organized 40 years ago to promote the
19 consumer interest, and home ownership is one of our
20 key concerns.

21 I just want to make four quick points and
22 observations that really came from the hearing.
23 Number one, we believe it's vital that the Fed act
24 swiftly and decisively to use its very broad authority
25 under HOEPA to rein in unfair and deceptive practices

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1 in the marketplace.

2 Mortgage abuses that are resulting in many
3 homeowners being placed in mortgages they cannot
4 afford, and facing the prospect of foreclosures.
5 We're going to submit written comments about the
6 substantive provisions that have been discussed here
7 today.

8 But I want to say the fact that so many
9 homeowners are at risk at this stage is an indication
10 that the current consumer protection laws are largely
11 obsolete and inadequate, which shouldn't come as a
12 surprise, because it's been over a decade since
13 consumer protection in this area has been enacted.
14 The market's changed a lot. Consumer protection has
15 not.

16 The second point is we heard throughout the
17 day, and I think it cannot be emphasized enough, is
18 that the subprime market works differently than other
19 segments of the mortgage market. It's a push market;
20 loans are not sold based on rates and terms, but
21 really on monthly mortgage payments.

22 Consumers have fewer choices, almost by
23 definition and therefore are subject and more
24 vulnerable to be taken advantage of, which was the
25 original rationale behind the enactment of HOEPA back

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1 in 1994.

2 Third, we believe the Fed's in a unique
3 position to level the playing field, that by adopting
4 substantive regulation in this area, it will apply
5 across the board to all lenders, in a way that
6 guidance cannot.

7 Lastly, enhanced Disclosure, which is a
8 concept we certainly agree with and support, is
9 necessary but ultimately insufficient to curb a lot of
10 the abuses that are occurring, and that substantive
11 regulation that would prohibit abusive practices will
12 need to be adopted by the Board as well. Thank you
13 very much.

14 GOVERNOR KROSZNER: Thank you very much.
15 I'd like to thank all of the speakers for sharing
16 their views, and their personal histories. These are
17 very important. I am well aware that this is about
18 not just big concepts and markets, but also about
19 individuals and families who are facing potential
20 tragedies in their lives.

21 It's very important that we undertake the
22 right actions, to make sure that we avoid those
23 personal tragedies as much as we can, and also make
24 sure to be able to provide credit, on a responsible
25 basis, to people who can handle it and who can make

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1 their lives better because of it.

2 I want to thank you very much again for
3 coming and sharing this day with us. It's been
4 incredibly valuable to me and I think to both Sandy
5 and to Leonard, and hopefully it was very valuable to
6 you. Thank you very much.

7 (Whereupon, at 3:56 p.m., the hearing was
8 adjourned.)

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